ENABLING LEARNERS' EXPLORATIONS IN BUSINESS STUDIES & ACCOUNTANCY

MODULE - 1

2016-17

MANUAL FOR
LECTURERS IN COMMERCE

WORLD OF BUSINESS - ONE REALITY SEVERAL FACETS

STATE COUNCIL OF EDUCATIONAL RESEARCH AND TRAINING
Varun Marg, Defence Colony, New Delhi – 110024

ENABLING LEANERS' EXPLORATIONS IN
BUSINESS STUDIES
&
ACCOUNTANCY

UNINCORPORATED BUSINESSES

YEAR-2016-17

स्वाध्यायान्मा प्रमदः

STATE COUNCIL OF EDUCATIONal RESEARCH & TRAINING

VARUN MARG, DEFENCE COLONY, N. DELHI -110024

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Foreword

The world of business is witnessing development and changes coming too fast and thereby demanding our attention for commerce curriculum at the senior secondary stage. Every learner in a dynamic learning society has to be familiarized with such areas of knowledge in the global context. Commerce education is directly linked with such changes. The recent times has brought changes in the ways of doing business and has moved beyond the buyers and sellers' market. The advent of globalization of ers rethinking about the selection and delivery of instructional content and new sources of information in order to integrate Skills with knowledge. This requires the students to take an active role in the learning process that consequently results in better student retention and performance. The Information and Communication technology has come in a massive way enabling the occurrence of business transductions digitally on the electronic platform.

The apex organizations like NCERT and CBSE have been incorporating these changes by introducing Project work, VBQs, HOTS, and Case Studies etc., to bring children close to the real world of work. SCERT organises Capacity Building Programs to enable the teachers of commerce for effective classroom transaction and teaching-learning processes. This time SCERT has re-designed its training by developing six modules based on critical components identified across the XI & XI syllabus at Senior Secondary stage and a Supplementary handbook containing enrichment material. Module based training wil be organised for all teachers. However, all the modules wil be made available to the teachers for reference purposes.

I, hereby, extend a sincere word of appreciation for the entire team of contributors who have brought these modules in present shape. It was a tremendous task that would not have been possible without the vision and passion of the people who have incorporated interactive activities, recent changes in syllabus, innovative methodology of teaching-learning processes and enriching reading material for teachers.

I extend a deep sense of reverence and gratitude to all concerned authorities; DOE, NCERT and CBSE for extending all academic support for incorporating required content in the Modules for capacity building of Lecturers in Commerce.

We look forward for your continued support and academic associations for quality education and capacity building of teachers.

I sincerely wish and hope teachers wil also take it enthusiastical y with same zeal and passion to their classrooms.

Your observations and suggestions are welcome on the modules.

Anita Satia

Director, SCERT

Editorial

Today is the age of commerce. It has brought about revolutionary and radical changes in all walks of life. Doing business has taken a new shift which has broken the traditional confines of buyers and sellers' market and the way goods and services are bought and sold. Modes of payment and emerging modes of E-business have encouraged buyers to use technology in day to day life. The gap between domestic and International markets has narrowed down due to the technology. Consumer awareness has also taken a paradigm shift. Competition has become tough. ***It is in this backdrop, all teachers teaching Commerce at Senior Secondary level have to keep pace with fast changing world of business to relate the content of textbooks to the changing business scenario***. It is a chal enge and at the same time exciting, as the subject is not static.

The NCERT and CBSE keep updating the methodology and assessment to make the subject pragmatic and giving teachers and students' scope to think beyond textbooks. Moreover it's the teachers' responsibility to introduce the subject in an interesting manner as Commerce as a subject is introduced at senior secondary level. SCERT organises orientation every year for teachers to update you on the same including hard spots and changes in syllabus and assessment.

This time it has been re-designed by developing six modules based on critical components identified across the XI & XII syllabus at Senior Secondary stage and a Supplementary Handbook containing enrichment material. Questioning based on Blooms Taxonomy and Question Paper Design, Case Studies, Project Work, HOTS, are major areas that wil be addressed during Training Program for Teachers along with hard spots and reading material from class XI syllabus also.

These Modules address the significant changes in Curriculum, Assessment Practices. The useful reading material wil help you in your classroom Teaching–Learning processes. As Teachers play an important role in implementing all new changes taking place in the curriculum and also the new technologies in the field of education. It wil provide an insight on all aspects and stages of project work. A list of suggestive Projects is also given to improve the quality of Projects corresponding to the learning objectives stated by CBSE.

NCERT and CBSE have brought in the desirable changes in the textbooks and examination pattern to connect the text with real world of work in true sense. NCF 2005 also strongly emphasizes on the departure from rote learning to child cantered- processes which is the core of Constructivist approach. The support material developed by SCERT / DIET is an initiative in this direction for capacity building of teachers.

I appreciate team of Contributors who have worked tirelessly and brought these Modules in the present shape. Special thanks are extended to the core committee members comprising of Dr. Anand Saxena, Prof. Shipra Vaidya and Mr. Vijay Kumar who have extended me their invaluable inputs for final vet ing and editing of Modules.

A tribute goes for the noted Educationist, Minoo Nandrajog, who co-authored NCERT books for school children passed away on Wednesday (23 December, 2015 after brief illness. Nandrajog was working as a Professor of Commerce with the NCERT. During her stint, she helped author books in Business Studies and Finance for school students studying commerce. She was associated with SCERT/DIETs for the last two decade in designing Training Curriculum and Orientation Programs of Teachers of DOE in Commerce. Her vibrancy and involvement in our Programs as Resource Person wil be intensely missed as teachers used to relate to her very spontaneously and affectionately. We wil miss her intel ectual associations in Commerce Education.

I take this opportunity to express a deep sense of reverence and gratitude to Ms. Anita Satia, Director, SCERT, Dr. Nahar Singh, Joint Director, SCERT and Late Dr. Pratibha, Former Joint Director, SCERT for their continuous support and encouragement. I owe special thanks to Dr. Dushyant Kaur, Principal DIET Moti Bagh and all my col eagues; Academic and Administrative Staf for facilitating and extending unconditional support at all stages of completing this assignment. My sincere thanks are extended to Ms. Sunita Rani, Lecturer, DIET, Moti Bagh who has provided her valuable inputs and has been a constant support at all stages of development of these Modules. Special thanks are extended to the team of Contributors, Subject Experts, and their concerned authorities, Faculty of various Col eges /Institutes, DDEs and Officials of Directorate, Principals and Teachers of Government Schools, Aided / Public Schools for providing valuable suggestions and support at all stages of development of this Modules. I wish all Stakeholders an

insightful reading.

The observations, suggestions and comments related to the Manual are welcome.

*The brief of all Modules are given in the following pages.

Dr. Seema Srivastava

ABOUT THE MODULES

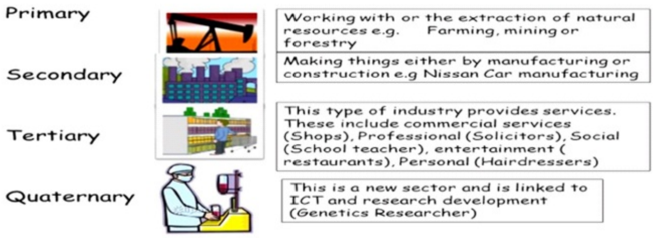
-An Introductory Note

The present enrichment material is integrative in nature and contains 6 Modules and Supplementary handbook for teachers. Each module deals with a different set of selected topics from the senior secondary CBSE syllabus of Commerce, applicable from session 2016-17 onwards. Every Module covers syllabus topics from both Class XI and Xii. The topics have been included after a thorough brainstorming with experts and feedback received from in-service teachers of Commerce, especially those recently promoted into teaching of Commerce. Commerce stream draws heavily on subjects like Geography, Civics, History, Mathematics, Languages and so. The principles of Scientific Management by Fredrick Winslow Tailor are based on organisation and Decision Theory. An in depth look wil reveal mathematics and statistics are employed in many different areas of Industry, Commerce and Accounting Procedures.

The objective is very clear: to enable the teachers to upgrade their knowledge and develop their capacity to become better facilitators in teaching-learning Commerce. To this end many current related news/ happenings, links to websites, topic wise key terms, photographs / pictures /images, Case Studies, games and projects, guide notes for teachers, Value Based Questions, Life Skills and Higher Order Thinking Skills (HOTS) have been included in every module. Use of these wil surely make every class of commerce abuzz with discussion, debate and activity. Difficult topics have also been explained. Without going overboard, it can be stated to serve as a quick reckoner and repository of related material for teachers.

A brief description of the Modules, divided into topical units, is as follows so teachers can decide to go through these as per their individual requirement and choice. all modules wil be uploaded on SCERT website for reference.

Module - I Foundations of Commerce – One Reality, Several Facets



This contains four units. Unit-1 deals with spectrum of different activities i.e. Industry, Trade and Commerce. For class XI students this is an altogether new experience of understanding business, trade and auxiliaries to trade, various types of activities in which we all keep ourselves busy to satisfy our wants. You will learn in detail about 'Business' as a human activity. Business plays a vital role in our lives, not only by providing us various goods and services but also by of ering many opportunities to earn our livelihood. This unit has been designed to help the learner to identify the scope of business activities and to understand the various business activities viz., Industry, Trade & Commerce. Various activities and exhibits are given to make it interesting and it will enable you to relate the text with world of work.

Unit – II of Module intends to familiarize the readers with the concept and theory of Management. It also acquaints the reader about the various Principles of Management that have been applied over the years, along with the techniques of Scientific Management. This unit will help readers understand how management enables organization to be successful in achieving their goals. Co-ordination as an essence of Management, Principles of Management and Levels of Management has been discussed with examples. It gives you lot of insights on classroom processes and how to deal Case Studies given in textbook.

In **Unit - III** we sail through the Business aim to earn profit by providing goods and services to the people through using various resources, material resources and non- material. Material resources include Assets like Land & Building, Plant & Machinery, Investments and Funds available with the business etc. The body of knowledge which helps in providing information about the resources available to the business and how efficiently and effectively the available resources have been used by the business is known as accounting. Accounting is considered as the language of the business as it helps in communicating the results of its activities to the various stakeholders interested in such information. The unit elaborates on the meaning and process of preparing the Accounting Equation based on the different transactions. Unit - IV is on Reconstitution of Partnership Firms- on Admission of a New Partner. When firm requires additional capital or managerial help or both for the expansion of its business a new partner may be admit ed to supplement its existing resources. The unit exposes you with various accounting treatment on account of this and how to deal with it. Hard spots and illustrations are also taken up.

Module- I - Unincorporated Businesses

Unit-I deals with the Smal / Unincorporated Business - Choice of Forms of Business Organisation. Incorporated businesses are formed by following a process of incorporation or registration. We are aware that it is not mandatory to register a firm. Then why include partnership in this module? There are two broad reasons. One is the benefits of registration, secondly and introduction of Limited Liability Partnership (LLP). The unit wil enable you to explore here salient aspects of incorporated businesses and accounting issues linked with these ownership forms. Many recent case studies like Amul, Lizzat Papad etc. have been included to relate the various forms for better comprehension of concepts in real business scenario.

Unit- II elaborates on Risks, Rewards of Business & Insurance. Business is ful of uncertainties. Uncertainties can be of different forms like loss due to change in fashion; fal in market price; goods produced may be destroyed by fire, storm, cyclone, theft etc. Thus, while running a business enterprise, there is an element of risk. Business risk means chance of loss due to uncertain events in future.

Businesspersons are ready to bear these risks because they want to earn profit. In view of the above we can say that in expectation of profit they bear business risks.

In this unit learners wil explore about the role of profit in business, various types of business risks and their causes.

All of us have seen shops in the market. In these shops goods are stored for sale. We have seen factories where machines are installed to manufacture products. We know about modes of transportation viz: land water and air which carry goods from one place to another. Alll these involve lot of money and there is always a risk of loss in transit. The damage may be due to accidents like fire, natural calamities or even riot or theft. Can these risks be avoided or minimized? Is there anything to take care of these risks? The unit exposes you the various types of Insurance including real case studies on settled / disputed to get the clarity of clauses that are practiced. These are exemplar for classroom discussions. You may explore more on your own.

Unit - III – Accounting for Unincorporated Businesses, Partnership Firms, Companies & Co-operatives and Limited Liability

Unit exposes readers to the accounting for Unincorporated Businesses (Accounting for Partnership- Reconstitution, Change in PSR & Admission (Special Focus on Cases of Capital Adjustments)

Unit - IV covers the details of financing the Business- Sources of Business Finance. Finance is the life blood of any organization. The existence, survival and growth of the business depend on finance. The requirement of the finance in the form of fixed capital and working capital is dependent on its size and scale of operations.

The business can acquire its finance for short-term and long-term through various sources. A careful and effective financial planning wil ensure adequate availability of funds at lowest cost and all ocation & utilization of these funds for maximum benefits.

One needs to know about the various options available to them to arrange the required amount of funds (also called capital). In this unit, you wil find out the answer to such questions. Having learnt about the need, importance and types of financial requirements, now we must know from where the businessmen get the required amount of funds to meet the short-term, medium term and long term requirements. Who provides them the required amount? You wil learn about the various sources from which the businessmen generally arrange money for business purposes.

Module - III

MAKEOVER STRATEGY

Good news

- Solution in sight to the spat between the finance ministry and the postal department over converting post offices under India Post into a bank
- India Post may apply for payment bank licence
- RBI and postal department were keen on universal bank licence but finance ministry opposed the move

What's a payment bank?

- Payment banks can provide deposit and remittance services but not give loans

The strengths

- Huge network of post offices will help to bring rural and semi-rural areas within bank ambit
- India has around 1.54 lakh post offices with around 150 million savings accounts, who are seen as potential customers for Jan Dhan

The weakness

- Post offices have a long way to go to catch up with the professionalism of modern day banks

Unit-1 – Partnership, Company and Cooperative forms of Business Organisations, Limited Liability Partnership-Various forms with their merits and demerits are discussed in this unit along with examples and exhibits. History of Companies Act legislated in India and Impact of Companies Act -2013 is included in this unit with ample examples. Cooperative Form of Business -groups of individuals around the world and throughout time have worked together in pursuit of common goals. Examples of cooperation, or col ective action, can be traced back to our prehistoric predecessors who recognized the advantages of hunting, gathering, and living in groups rather than on their own are also covered.

Unit – II is on the Concept of Corporate Governance-Its Philosophy and Practice.

The concept of corporate governance is not new to India. Many corporations/ companies are known for following the concept of good governance affecting various stakeholders, particularly the vulnerable one in a positive manner. However, corporate governance as a concept in India got prominence in the wake of liberalisation, privatisation and globalisation (L.P.G) policies adopted by the government during 1990s and was introduced by industry representative associations like Confederation of Indian Industries (CII) as a voluntary measure to be adopted by the Indian companies. Soon it acquired a legal status in early 2000s through the introduction of clause 49 of the listing agreement as all companies, with a particular share capital, listed on stock exchanges were required to comply with these norms of corporate governance.

Good corporate governance standards are essential for the integrity of corporations, financial institutions and markets and have a bearing on the growth and stability of the economy. Over the past decade and a half, India has made significant strides in the areas of corporate governance reforms, which have improved public trust in the market. These reforms have been wel received by the investors, including the Foreign Institutional Investors (FIIs). Corporate Governance by Narayana Murthy Committee, Corporate Governance by Narayana Murthy Committee, Excerpts from Corporate Governance at Tata Group, Excerpts from Corporate Governance at Reliance Industries wil really enrich you on how these renowned companies philosophise, think, follow and practice Corporate Governance. Various contemporary case studies are also suggested for classroom discussions to build a sound understanding of Corporate Governance.

Unit - III deals with Private and Public Enterprises; Change in the role of Public Sector Enterprises in an economy, Public-Private Partnership

India, after independence, has followed the concept of Mixed Economy. Mixed economy consists of Public sector as wel as Private Sector. Public Sector in India has been an integral part of growth and development process of its economy. Some public sector enterprises/undertakings (PSUs) have been the backbone of Indian economy. PSUs like Indian Oil, ONGC, BHEL, NTPC etc. have done wel for the welfare of the people in an economically efficient and effective manner. Private Sector Enterprises flourished after new economic policy was adopted following principles of LPG i.e. Liberalization, Privatization and Globalization. New business houses emerged after 1990s new economic policy include, Dhiru Bhai Ambani's Reliance Group, Sunil Bharti Mit al's Bharti Group, Narayan Murti's Infosys, Azim Premji's Wipro etc. Some companies are also following the Public-Private Partnership Model which offers benefits of both sectors. The different case studies and changing role of public sector wil catch your attention as to how the sectors are evolving in economy. Public Private Partnership (PPP) is gaining at ention to improve upon the quality of infrastructure and services.

Unit – IV covers **Accounting** for Partnership Firms – Retirement, Death of a Partner and Dissolution of Partnership.

Accounting for partnership firms is based on the concepts learned in the previous modules related with Partnership

Accounting. In this unit, accounting procedures in case of Retirement of the partner/partners from the firm, Death of Partner/partners and in case of dissolution of Partnership firms has been given along with illustrations.

Module - IV Banking and Finance

Unit - I Banking, Banking Transactions: Types of Bank Accounts (Focus on RD & MODS, NEFT)*, E-Banking, Bank Draft, Bankers' Cheque

Banking: Concepts and Its Emerging Modes elaborate on various activities performed\ by a businessman while carrying out the business operations are taken up in this unit. Thus, to carry out any business activity successfully, various support services are required. The unit gives you an idea about those services and their operations. In this unit we shal learn about banking which is a main support service for any business.

E-Banking - **Range of services offered by e-banking are: like** Electronic Funds Transfer (EFT), Automated Tel er Machines (ATM), Point of Sales (POS), Electronic Data Interchange (EDI), Digital Cash etc. are taken up with specimens/exhibits/ procedures are covered to make it easy to understand. RTGS, NEFT etc. are also explained. FAQs are given in almost each unit along with HOTS and Board questions.

Unit - II deals with Sources of Business Finance. Various sources are explained with its merits and demerits.

Unit – III deals with Bank Reconciliation Statement. It is necessary for every business organisations to keep a record of their cash and bank transactions in a cash book. The cash book also serves the purpose of both the cash account and the bank account as it shows the balance of both cash and bank at the end of the period.

After the balancing of cash book, it is usual to check its details with the records of the recent bank statement (or a bank passbook) obtained from the bank. A bank statement or a bank passbook is a copy of a bank account as shown by the bank records. This enables the business enterprises to check their funds in the bank regularly and update their own records of transactions that have occurred. The amount of balance shown in the passbook or the bank statement must tally with the balance as shown in the cash book of the business. But in practice, these are generally found to be different. Hence, we have to ascertain the causes for such difference. The unit elaborates on the meaning, need and process of preparing the Bank Reconciliation Statement based on the different transactions causing the differences between two balances. An exemplar Project on BRS is also given in unit -6 for practice.

Unit - IV is on Accounting for Companies, Shares and Debentures. In class XI the students have already read about the company as a form of organisation, its features, merits and limitation along with types of companies and formation of a company. In this unit some hard spot in accounting for Share Capital and Debentures are discussed. In current academic session CBSE re-introduced topic redemption of debentures by conversion method and in share capital 'Accounting treatment of ESOP" is also explained in the unit. Stock market is different from a stock exchange which is an entity (a company or Corporation) in the business of bringing buyers and sellers of stock together. i.e., the stock market in the United States includes the trading of stocks listed on the NYSE, NASDAQ and Amex etc. In India, stock market includes the trading of stocks listed on the BSE, NSE etc. The unit has reading material on Stock Market and Financial Statement Analysis.

Module - V International Business and E-Business

Unit - I is based on **International Business and Global Enterprises: MNCs and Joint Venture**

With the development of human society and progress in science and technology, the scope of trade has also widened. It has now crossed the geographical boundaries of each country. Today, we can buy goods of our need from other countries and also sel our surplus goods abroad without facing much difficulty. When the business firms of two different countries participate in the process of buying and sel ing of goods it is termed as External Trade. Meaning and Features of Multi National Corporation (MNCs), Features of Global Enterprises and Joint Ventures are also explained.

UNIT- II is on E-Commerce-Emerging Modes of Business, App-Based Businesses.

In the last two decades the whole business scenario has changed drastically majorly due to technology revolution. The methods of the business are not the same. Most of the traditional business houses have changed their strategy to cope up with the changing business scenario. Even a large number of customers in the market are not going to the markets for satisfying their needs. Now –a - days we can see a number of business houses which are not manufacturing even a single unit themselves but generating a large volume of businesses in the market. Mode of payment has also been changed and now customers in the market have number of options. Present module wil discuss the emergence of new modes of business in the market, uses of smart cards and the concept of outsourcing. All this is elaborated in detail with specimen, details and examples /exhibits.

Unit - III provides a deeper understanding of New Initiatives and Policies of Government.

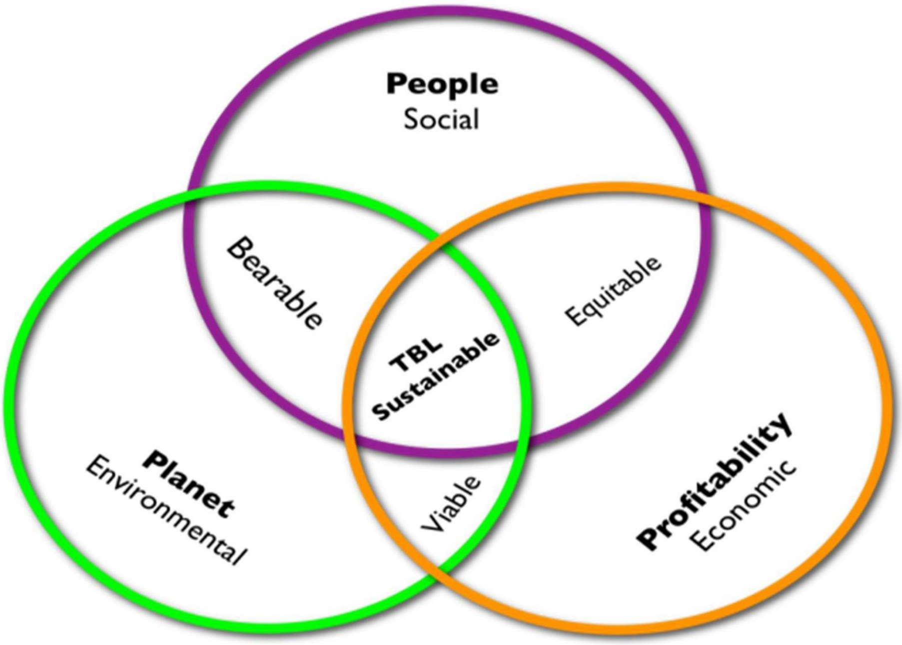
Globalisation is defined as the integration between countries through foreign trade and foreign investments by multinational corporations (MNCs). Integration of production and integration of markets is a key idea behind understanding the process of globalisation and its impact. MNCs have been a major force in the globalisation process connecting distant regions of the world. More and more goods and services, investments and technology are moving between countries. Various Government policies are aimed at addressing the economic problems faced by the Indian economy. They are framed so as to prepare the economy to face the challenges and prepare the same for the new opportunities emerging out of integration of the Indian economy with the world. The unit exposes you with various Government policies and Schemes. Steps to at ract foreign investment and benefits of globalisation throw light on Government interest and intent. Make in India , Skil Development, Start Ups and Swacch Bharat, Jan-Dhan Yojna etc. are explained for classroom discussion and debate.

Unit - IV is on E-Accounting (tally Software)

The aim of this chapter is not to teach an accounting package, but to focus on how thefeatures of accounting software are implemented in cycle can be incorporated in the flow. It also co-relates the manual phases of accounting cycle with each of these modules and describes how different reports can be generated at the end of each of these modules. **Features of accounting software** are explained in this unit.

Tally is an accounts and inventory management software which has many other features too. With the latest version of this software tally 9 you can- do all basic accounting functions.

Module - VI Business Environment and Sustainable Businesses



Unit-1 explains Ethical and Environmental Responsibilities of Business-

Understanding Business Environment and Social, Accounting for Sustainable Businesses

This module is integrative in nature. It is integrative in many ways. One, we look at business and business studies in the context of the set ings in which they operate. Two, we emphasize that the only in economic terms but also how it contributes toward the development of the society and the conservation of the environment. The opening unit therefore explores the salient aspects of the symbiotic relation environment. Three, it emphasizes that the conventional dichotomy of the economic and social activities is get ing blurred. Today we talk of social entrepreneurship and social businesses. In any case, even the Government focuses on efficiency and effectiveness. That is why we have included a unit on Not for Profit Organizations in this module. Fourth, the module contains our suggestions on Students' Project Work to be integrative even as it may emphasize a particular business functionality or environmental issue. The figure on the cover of the module says it all . We zoom it in here to put the module in a better perspective.

It would be too inappropriate to say that the purpose of the business is to earn profits. Business is a social institution and the purpose of business is to help the society in raising its living standards by providing job opportunities, goods and services, technology, expert guidance to the government in making plans and policies.

Unit - III Accounting for Not-for-Profit Organisations

Every organisation in the society is not set up with the objective of earning profits but with the objective of providing service to its members and the public in general. Such organisations include clubs, charitable institutions, schools, religious organisations, sports club, trade unions, welfare societies and societies for the promotion of art and culture. These organisations have service as the main objective and not the profit as is the case of business organisations. These organisations are managed by trustees who are fully accountable to their members and the society for the utilization of the funds raised. Hence, they also have to maintain proper accounts and prepare the financial statement which take the form of Receipt and Payment Account; Income and Expenditure Account; and Balance Sheet at the end of every accounting year. The unit contains the illustrations on the same to expose you with accounting procedures for such organisations.

Unit - III Explains the Functional Aspects of Business (Marketing, Finance and Human Resource- An overview)

Every organisation has to perform various functions in order to achieve its aims. Similarly business output i.e. goods and services, are the result of a complex mixture of activities. The success and failure of a business are heavily dependent on the effectiveness and efficiency of these functions. ***Finance, Human Resources, Production and Marketing*** of the products are some of the most important functions which business organisations have to keep in mind. The unit contains the cases based on these three aspect for an intensive classroom activity based on the analysis of each case by students in group activity followed by presentations .The deliberations wil develop analytical ability among students and it wil enable them to understand the case studies better from boards point of view as per the changed pattern of Paper. ***The unit further establishes the interconnectedness of the three - Marketing, Finance and Human Resource.*** Your role as teacher is most crucial to channelize and consolidate the presentations by students for clarity and comprehension of the three major functions. In the end the Exemplar SWOT method of Skoda is given to orient students to use this as analyzing the other case studies .You should encourage students to look for such cases and bring to classroom for debate and discussions.

Unit - IV provides the essentials and process of initiating authentic and original Project Work in Commerce.

NCF 2005 focuses on bringing the textbooks closer to the world of work. With the objective to impart application based insights the Project Work was introduced by CBSE in the Commerce Curriculum at the Senior Secondary Level.

The present unit also deals with the QUESTIONING SKILLS which wil expose you to interesting content and examples. It wil enable you to polish your own Skills to practice effective teacher–learning processes. In the course of various stages of developing the project, students have to be oriented to gather data and conduct interviews etc. The students should be encouraged to develop scientific temper as wel as the confidence and communication Skills to interact with various parties in the course of field research.

Data collected by the students should be subject to objective analysis and interpretation, for inferring unbiased conclusions. At every stage, teachers should help students to hone correct at itude and values for the task. In class XI, project work involves **field visits, case studies, import export procedures** and so for class XII , the projects include topics related to **Principles of Management, Business Environment, Stock Exchange and Marketing Management.**

Later in the unit Questioning Skills, Bloom's Taxonomy and Higher Order Thinking Skills are also explained with ample Examples.

The 6 Modules as briefly described above are support material and teachers wil gain by making use of these in their class. It should be clear that in no way at all this is an exhaustive material. It is meant to complement and not substitute the text books. This is a teacher's teaching aid. Using this wil surely make your students look forward to their Commerce class!

Supplementary Handbook for Teachers of Commerce

This contains the syllabus for the year 2016-17, CBSE Board Papers including Marking Scheme of CBSE Papers. Sample Paper of CBSE for the year 2016-17 is also included. Common Errors committed by the students are also detailed out to provide you an insight to prepare students to score better. The genuineness and authenticity of the project work largely depend on teachers' guidance and monitoring. As far as possible, project work should be executed in school, under the teacher's guidance and facilitation. The different aspects of Project formulation and different stages of project have been addressed in form of Frequently Asked questions (FAQs). You wil be amazed to find out what you teach in theory wil enable students to find meaningful application in daily newspapers. This wil also develop the habit of reading newspapers among students and sharpen their analytical ability too.

It would be our endeavour to bring back the glory to this noble task of teaching and meaningfully contribute to effective teaching- learning processes to make the students globally competitive. Alll the best and hope that creativity of users of these modules gets inspired to take flight beyond this resource. Take this with the same zeal andcompassion to make the teaching of Commerce joyful and meaningful. Your observations, comments and suggestions on the Modules are welcome.

Dr. Seema Srivastava

Welcome

On board!

The picture above depicts paper planes flying all over. Imagine being greeted by the students on the First day. As a commerce teacher in the class room what would you cal it? **A disaster or the commencement of a great innings ?** A teacher chooses later option by greeting back the learner with praise. Yes, plain paper does not fly: it is only when they are folded in specific angles, following the principles of aerodynamics that makes them fly. It is great to know that your learners are aware of this. The issue is how to leverage the learners' awareness and lead them to an exciting journey of exploring the subject they have chosen. Let us begin with study of-

- Principles of learning facilitation;
- Learners are more aware than we presume them to be;
- Every bit of learning needs to be celebrated with a reward;
- Learning is cumulative. What we learn in kindergarten adds up to what we learn in primary classes and so on;

- All learners are blessed with six able servants- what, Why, When, How, Where and Who;
- One may embark upon one's explorations in any subject from starting point.

One just has to let go!

ENABLING LEARNERS' EXPLORATIONS IN BUSINESS STUDIES AND ACCOUNTING

MODULE - 2

UNINCORPORATED BUSINESSES

Unit - I Forms of Business Organisation

Unit - I Risks and Rewards of Business & Insurance

Unit - III Reconstitution of Partnership - Change in Profit – Sharing Ratio and Admission of a Partner

Unit - IV Sources of Business Finance

UNIT-I

Forms of Business Organisations

Abstract

Business can be done by an individual, a smal group of persons or collectively by a large number of persons. Even the Government plays pivotal role in running priority sectors, however its sole purpose is not to earn profit but to serve the citizens. So, on the basis of ownership, there are different forms of business. The formation and operation of all the businesses differ according to the ownership of the business. The present unit wil expose the learners with business ownership and formation of different business organizations.

Key Terms

Unincorporated business

Sole Proprietorship

Partnership – Partnership Deed

Limited Liability Partnership

Joint Hindu Family Business- Karta & Coparcener

Co-Operative Society

Learning Outcomes

After studying this Module, Learners wil be able to:

- distinguish between the corporate and unincorporated forms of business organizations.
- discuss the merits and limitations of unincorporated businesses.
- state the meaning and characteristics of sole proprietorship along with its merits & limitations.
- state the meaning of partnership & its types
- list the advantages and limitations of partnership form of business organisation
- explain the concept of limited liability partnership
- explain Joint Hindu Family business
- explain the meaning of Co-operative Society along with its merits & limitations
- explain the meaning and characteristics of Joint Stock Company
- differentiate between Public Company and Private Company
- explain the merits and limitations of Joint Stock Company and its suitability
- identify the factors influencing the choice of an appropriate form of business

Introduction

In the Module –I, the spectrum of different activities: industry, trade & commerce; organisation management interface; theory base of accounting, accounting aspects of business were discussed. Let us now discuss about the forms of business organizations that exist to run business activities.

1. Sole Proprietorship

The Concept

Sole' means single and 'proprietorship' means ownership. It means only one person or an individual is the owner of the business. Thus, the business organization in which a single person owns, manages and controls all the activities of the business is known as sole proprietorship form of business organisation. The individual who owns and runs the sole proprietorship business is called a 'sole proprietor' or 'sole trader'. A sole proprietor pools and organises the resources in a systematic way and controls the activities with the sole objective of earning profit.

Image: Sole Proprietorship

Sole proprietorship is that form of Business in which a single person is solely/only responsible for all kinds of decision making related with the business.

Merits of Sole Proprietorship

The sole proprietorship form of business is the most simple and common in our country. It has the following advantages:

1. Ease of Formation and Closure :A sole proprietorship form of business is very easy to form. With a very smal amount of capital one can start the business. Legal formalities are minimum, just like formation; it is also very easy to close the business. It is the owners, sole discretion to form or wind up the business at any time.

2. Direct Motivation: The profits earned belong to the sole proprietor alone and he bears the risk of losses as wel . Thus, there is a direct link between ef ort and reward. If he/she works hard, then there is a possibility of get ing more profit and vice versa. This provides strong motivation for the sole proprietor to work hard.

3. Quick Decision and Prompt Action: In a sole proprietorship business the sole proprietor alone is responsible for all decisions. Since no one else is involved in decision making it becomes easy to take quick and prompt action on the basis of decision taken.

4. Better Control: In sole proprietorship business, the proprietor has ful control over each and every activity of the business. He is the planner as wel as the organiser, who co- ordinates every activity in an ef icient manner. Since the proprietor has all authority with him, it is possible to exercise better control over business.

5. Maintenance of Business Secrets: In the case of sole proprietorship business, the proprietor is in a very good position to keep his plans to himself since management and control are in his hands. There is no need to disclose any information to others.

6. Close Personal Relation: The sole proprietor is always in a position to maintain good personal contact with the customers and employees. Direct contact enables the sole proprietor to know the likes, dislikes and tastes of the customers. Alllso, it helps in maintaining close and friendly relations with the employees and thus, business runs smoothly.

Merits of Sole Proprietorship

Every business has some merits as wel as some demerits. Let’s understand the merits of Sole Proprietorship.

Figure: Merits of Sole Proprietorship

Limitations of Sole Proprietorship

One-man business is the best form of business organisation because of the above-discussed merits. However, all types of ownership have some limitations and the sole proprietorship is no exception. Let us learn those limitations.

1. Limited Capital: In sole proprietorship business, it is the owner who arranges the capital required for the business. It is often dif icult for a single individual to raise a huge amount of capital. The owner's own funds as wel as borrowed funds sometimes become insufficient to meet the requirement of the business for its growth and expansion.

2. Lack of Continuity: The existence of sole proprietorship depends on the owner. The business may come to an end as and when the sole proprietor so decides or in the event of his death.

3. Limited Size: In sole proprietorship form of business organization there is a limit beyond which it becomes dif icult to expand its activities. It is not always possible for a single person to supervise and manage the affairs of the business if it grows beyond a certain limit.

4. Lack of Managerial Expertise: A sole proprietor may not be an expert in every aspect of management. He/she may be an expert in administration, planning, etc., but may be poor in marketing.

Figure: Demerits of Sole Proprietorship

MEANING OF PARTNERSHIP

All the business activities are performed with some objectives. The objectives of business may be classified as -

Financial and managerial resources of Sole Proprietorship business are limited. It is also not possible to expand the business activities beyond a certain limit. In order to overcome these drawbacks, another form, i.e., partnership form of business has come into existence. It is basically a relation between two or more persons who join hands to form a business organisation with the objective of earning profit. The persons who join hands are individually known as 'Partner' and collectively a 'Firm'. The name under which the business is carried on is called 'firm name'.

A partnership firm is governed by the provisions of the Indian Partnership Act, 1932. Section 4 of the Indian Partnership Act, 1932, defines partnership as "a relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all ".

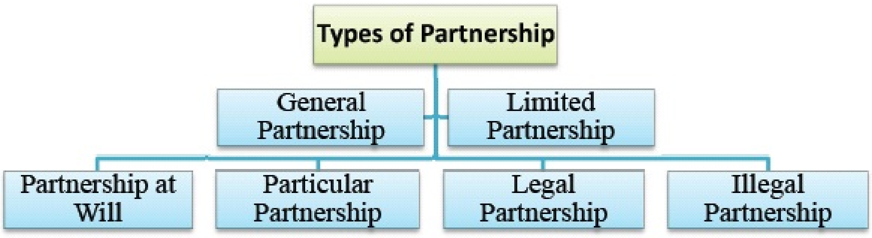
Partnership is that form of business organisation in which two or more persons agree to share the profits of a business carried on and financed by them per the aggreement (either in writing or implied)

Types of Partnership

Partnership can be categorised as under:

1. General and Limited Partnership: In the general partnership, the liability of the partners is unlimited, whereas limited partnership has two types of partners: General Partner and Special Partner. Liability of general partner is unlimited whereas liability of special partner is limited. There should be at least one general partner in the limited partnership.

Figure: Types of Partnership



2. Partnership at Will and Particular Partnership: Partnership at wil can be formed to run the business for an indefinite period, while particular partnership can be formed for some specific purpose and it ends with the at ainment of pre-determined specific purpose.

3. Legal and Illegal Partnership: although it is not essential to get the partnership registered under Indian Partnership Act, 1932 in order to bring it into existence, yet the partnership organisations have to work in accordance with the provisions of the Act. Those partnerships which work according to the provisions of the Act are considered legal and are called legal partnerships. On the contrary, partnership becomes Illegal or non-statutory in the following conditions:

i. If the purpose of the establishment of partnership is Illegal ,

ii. If the business of partnership is against public policy,

iii. If the number of partners reduces to one or exceed the maximum limits, and

iv. If there is any partner from an enemy country.

MERITS OF PARTNERSHIP

Partnership form of business organisation has certain advantages, which are as follows:

1. Easy to form– Like sole proprietorship, the partnership business can be formed easily without any legal formalities. It is not necessary to get the firm registered. A simple agreement, either oral or in writing, is suf icient to create a partnership firm.

2. Availability of large resources– Since two or more partners join hands to start partnership business it may be possible to pool more resources as compared to sole proprietorship. The partners can contribute more capital, more ef orts and also more time for the business

3. Balanced decisions– The partners are the owners of the business. Each of them has equal right to participate in the management of the business. In case of any conflict they can sit together to solve the problems. Since all partners participate in decision-making, there is less scope for reckless and hasty decisions.

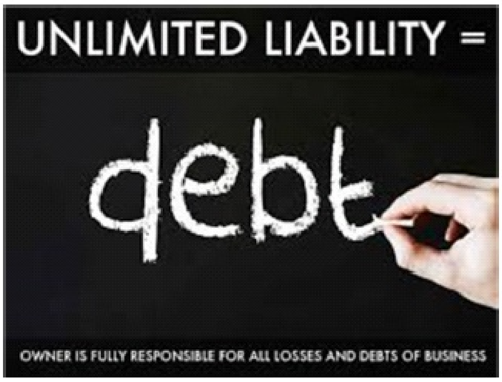
4. Sharing of losses– In a partnership firm, all the partners share the business risks. For example, if there are five partners and the firm suf ers a loss of 60,000 during a particular period, then all partners may share it and the individual burden wil be 12,000 only.

Figure: Merits of Partnership

LIMITATIONS OF PARTNERSHIP

In spite of all these advantages as discussed above, a partnership firm also suffers from certain limitations, and some of them are as follows:

1. Unlimited Liability – all the partners are jointly as wel as individually liable for the debts of the firm to an unlimited extent. Thus, they can share the liability among themselves or any one can be asked to pay all the debts even from his personal properties.

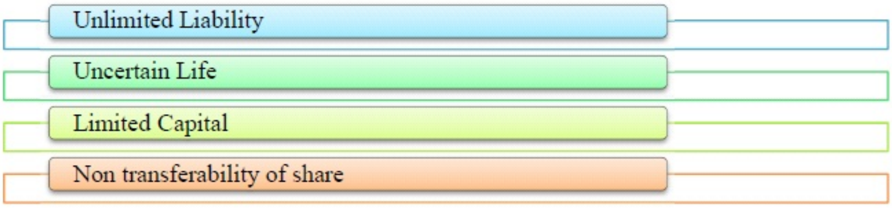


2. Uncertain Life– The partnership firm has no legal entity separate from its partners. It comes to an end with the death, insolvency, incapacity or the retirement of any partner. Further, any dissenting member can also give notice at any time for dissolution of partnership.

3. Limited Capital– Since the total number of partners cannot exceed 50, the capital to be raised is always limited. It may not be possible to start a very large business in partnership form.

4. Non transferability of share–A partner of a firm cannot transfer his/her share of interest without the consent of other partners. This creates inconvenience for the partner who wants to leave the firm or sel part of his share to others.

Figure: Demerits of Partnership



Registration of Partnership Firm

The partners should get their firm registered with the Registrar of Firms of the concerned state. Although registration is not compulsory but to avoid the consequences of non-registration it is advisable to get it registered when it is setup or at any time during its existence. The procedure for registration of a firm is as follows.

(i) The firm wil have to apply to the Registrar of Firms of the concerned state in the prescribed form.

(ii) The duly filled in form must be signed by all the partners.

(iii) The filled in form along with prescribed registration fee must be deposited in the office of the Registrar of Firms.

(iv) The Registrar wil scrutinize the application, and if he is satisfied that all formalities relating to registration have been duly complied with, he wil put the name of the firm in his register and issue the Certificate of Registration.

Partnership Deed

There must be an agreement among the partners to carry on the business and share the profits and losses. This agreement must preferably be in writing and duly signed the all the partners. The agreement, i.e., the partnership deed must contain the following:

(i) Name of the firm

(ii) Nature of the business

(iii) Names and addresses of partners

(iv) Location of business

(v) Duration of partnership, if decided

(vi) Amount of capital to be contributed by each partner

(vii) Profit and loss sharing ratio

(viii) Duties, powers and obligations of partners.

(ix) Salaries and withdrawals of the partners

(x) Preparation of accounts and their auditing

(xi) Procedure for dissolution of the firm etc.

(xi) Procedure for settlement of disputes

Types of Partners

1. Based on the extent of participation in the day-to-day management of the firm partners can be classified as 'Active Partners' and 'Sleeping Partners'. The partners who actively participate in the day-to-day operations of the business are known as active partners or working partners. Those partners who do not participate in day-to-day activities of the business are known as sleeping or dormant partners. Such partners simply contribute capital and share the profits and losses.

2. Based on sharing of profits the partners may be classified as 'Nominal Partners' and 'Partners in Profits'. Nominal partners allow the firm to use their name as partner. They neither invest any capital nor participate in the day-to-day operations. They are not entitled to share the profits of the firm. However, they are liable to third parties for all the acts of the firm. A person who shares the profits of the business without being liable for the losses is known as partner in profits. This is applicable only to the minors who are admit ed to the benefits of the firm and their liability is limited to their capital contribution.

3. Based on Liability, the partners can be classified as 'Limited Partners' and 'General Partners'. The liability of limited partners is limited to the extent of their capital contribution. This type of partners is found in Limited Partnership firms in some European countries and USA. The partners having unlimited liability are called as general partners or Partners with unlimited liability. It may be noted that every partner who is not a limited partner is treated as a general partner.

4. Based on the behaviour and conduct exhibited, there are two more types of partners besides the ones discussed above. These are (a) Partner by Estoppel; and (b) Partner by Holding out. A person, who behaves in the public in such a way as to give an impression that he/she is a partner of the firm, is called 'partner by estoppel'. Such partners are not entitled to share the profits of the firm, but are fully liable if somebody suf ers because of his/her false representation. Similarly, if a partner or partnership firm declares that a particular person is a partner of their firm, and such a person does not disclaim it, then he/she is known as 'Partner by Holding out'. Such partners are not entitled to profits but are fully liable as regards the firm's debts.

LIMITED LIABILITY PARTNERSHIP: CONCEPT

With the growth of the Indian economy, the role played by its entrepreneurs as wel as its technical and professional manpower has been acknowledged international y. It is felt opportune that entrepreneurship, knowledge and risk capital combine to provide a further impetus to India's economic growth. In this background, a need has been felt for a new corporate form that would provide an alternative to the traditional partnership, with unlimited personal liability on the one hand, and, the statue-based governance structure of the limited liability company on the other, in order to enable professional expertise and entrepreneurial initiative to combine, organize and operate in flexible, innovative and ef icient manner. Keeping in mind the need for the day, the Parliament enacted the Limited Liability Partnership Act, 2008 which received the assent of the President on 7th January, 2009.

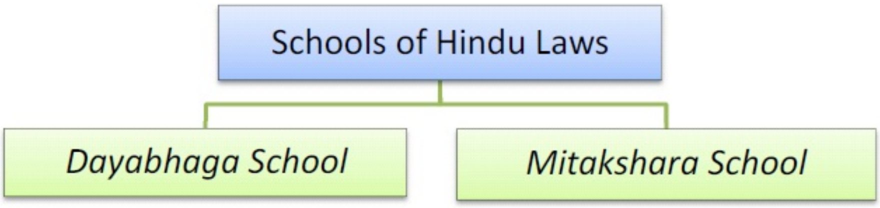
A corporate business vehicle that enables professional expertise and entrepreneurial initiative to combine and operate in flexible, innovative and ef icient manner, providing benefits of limited liability while allowing its members the flexibility for organizing their internal structure as a partnership.

HINDU UNDIVIDED FAMILY

Hindu Undivided Family (HUF) or a Joint Hindu Family Consists of all males lineal y descended from common ancestor their wives and daughters. Any married Hindu, Sikh, Jain or Buddhist man can form HUF. There are two schools of Hindu Law i.e. Dayabhaga School and Mitakshara School.

Image: Hindu Undivided Family

Figure: Schools of Hindu Laws



Dayabhaga School of Hindu Law	Mitakshara School of Hindu Law
Father is the **sole owner** and the **exclusive possessor** of the joint family property.	Law-property **vests** in the **HUF** itself and **not** in any **individual member** of the family.
No member can enforce the **partition** of the HUF so long as the **father lives**	It can be **partitioned within the lifetime** of the **father**.
Prevalent in : -West Bengal -Assam	Hindus in the rest of the country
Less Popular	More Popular

CO-PARCENERS:-

1. Some of the members of HUF are designated as coparceners.

2. All coparceners are members of HUF, all members are NOT coparceners.

3. Husband & Wife form HUF; wife can only be member, NOT coparcener.

4. Coparcener is different from the other members of HUF; coparceners are those members who acquire by birth an interest in the joint property of the family.

5. Coparcenary is restricted to four levels of living order.

6. Daughters also coparcener w.e.f. 9.9.2005 in the Hindu Succession (Amendment) Act, 2005.

7. After Hindu Succession Act amendments equal rights to daughters even after marriage. Married women have rights in two HUFs-their father's as coparcener and their husband's as member.

8. Members of the family who are not coparceners- No right to claim partition.

9. Daughter of a coparcener shal by birth become coparcener in her own right in the same manner as son.

Who can be a KARTA of HUF?

Senior most member of the family can be a Karta. Unmarried daughter, in the unfortunate event of her father passing away, wil become Karta. If all male members are minors & natural guardian is mother then she is the Karta. The Karta have various duties that are managing the affairs of HUF, Maintaining the books of accounts, filing tax returns for HUF, to enter in to contracts, form partnership firm, or representation on behalf of HUF.

COOPERATIVE SOCIETY: Concept

There are certain organisations which undertake business activities with the prime objective of providing service to the members. Although they also earn some amount of profit, but their main intention is to look after some common interest of its members. They pool available resources from the members, utilise the same in the best possible manner and share the benefits. These organisations are known as Cooperative Societies. Let us learn in detail about this form of business organisation. Those who want to work together with some common economic objectives can form a society, which is termed as cooperative society. It is a voluntary association of persons who work together to promote their economic interest. It works on the principle of self-help and mutual help. The primary objective is to provide support to the members. People come forward as a group, pool their individual resources, utilise them in the best possible manner and derive some common benefits out of it.

Types of Cooperative Societies

According to the needs of the people, we find different types of cooperative societies in

India. Some of the important types are given below.

1. Consumers' Cooperative Societies: These societies are formed to protect the interests of consumers by making available consumer goods of high quality at reasonable price.

2. Producer's Cooperative Societies: These societies are formed to protect the interest of smal producers and artisans by making available items of their need for production, like raw materials, tools and equipment etc.

3. Marketing Cooperative Societies: To solve the problem of marketing the products, smal producers join hands to form marketing cooperative societies.

4. Housing Cooperative Societies: To provide residential houses to the members, housing cooperative societies are formed generally in urban areas.

5. Farming Cooperative Societies: These societies are formed by the smal farmers to get the benefits of large-scale farming.

6. Credit Cooperative Societies: These societies are started by persons who are in need of credit. Credit Co-operative Societies accept deposits from the members and grant them loans at reasonable rate of interest.

Merits of Cooperative Society

The cooperative society is the only form of business organisation which gives utmost importance to its members rather than maximising its own profits. Cooperative society has certain advantages, which are as follows:

1. Easy to Form: Any ten adult members can voluntarily form an association get it registered with the Registrar of Cooperative Societies. The registration is very simple and it does not require much legal formalities.

2. Limited Liability: The liability of the members of the cooperative societies is limited up to their capital contribution. They are not personal y liable for the debt of the society.

3. Open Membership: Any competent like-minded person can join the cooperative society any time he likes. There is no restriction on the grounds of caste, creed, gender, colour etc. The time of entry and exit is also generally kept open.

4. State Assistance: The need for country's growth has necessitated the growth of the economic status of the weaker sections. Therefore, cooperative societies always get assistance in the forms of loans, grants, subsidies etc. from the state as wel as Central Government.

5. Stable Life: The cooperative society enjoys the benefit of perpetual succession. The death, resignation, insolvency of any member does not affect the existence of the society because of its separate legal entity.

6. Tax Concession: To encourage people to form co-operative societies the government generally provides tax concessions and exemptions, which keep on changing from time to time.

7. Democratic Management: The cooperative societies are managed by the Managing Committee, which is elected by the members. The members decide their own rules and regulations within the limits set by the law.

Limitations of Cooperative Society

Although the basic aim of forming a cooperative society is to develop a system of mutual help and cooperation among its members, yet the feeling of cooperation does not remain for long. Cooperative societies usual y suffer from the following limitations.

1. Limited Capital: Most of the cooperative societies suf er from lack of capital. Since the members of the society come from a limited area or class and usual y have limited means, it is not possible to col ect huge capital from them. Again, government's assistance is often inadequate for them.

2. Lack of Managerial Expertise: The Managing Committee of a cooperative society is not always able to manage the society in an effective and efficient way due to lack of managerial expertise. Again due to lack of funds they are also notable to derive the benefits of professional management.

3. Less Motivation: Since the rate of return on capital investment is less, the members do not always feel involved in the af airs of the society.

4. Lack of Interest: Once the first wave of enthusiasm to start and run the business is exhausted, intrigue and factionalism arise among members. This makes the co-operative lifeless and inactive.

JOINT STOCK COMPANY

A Joint Stock Company or simply a company is a voluntary association of persons generally formed for undertaking some big business activity. It is established by law and can be dissolved by law. The company has a separate legal existence so that even if its members die, the company remains in existence. Its members contribute money for some common purpose. The money so contributed constitutes the capital of the company. The capital of the company is divided into smal units called shares. Since members invest their money by purchasing the shares of the company, they are known as shareholders and the capital of the company is known as share capital. In India, the joint stock companies are governed by the Companies Act, 2013. According to the Act, a company means 'a company formed and registered under this Act or an existing company'. An existing company means a company formed and registered under any of the previous Companies Acts. This definition is not exhaustive enough to reveal the basic features of the company. However, based on the definition given in the previous Companies Act and various judicial decisions, it can be defined as 'an artificial person created by law, having a separate legal entity, with a perpetual succession'.

MERITS OF JOINT STOCK COMPANY

A company form of business organisation is very popular for undertaking big business. It has the following merits:

1. Large Resources: A joint stock company can raise large financial resources because of its large number of members and it can raise funds through debentures, public deposits, loans from financial institutions without muc difficulty.

2. Limited Liability: In a joint stock company the liability of its members is limited to the extent of shares held by them. This at racts a large number of smal investors to invest in the company. It helps the company to raise huge capital. Because of limited liability, a company is also able to take larger risks. This helps in making investment decisions easily.

3. Continuity of Existence: A company is an artificial person created by law and possesses independent legal status. It is not af ected by the death, insolvency etc. of its members. Thus, it has a perpetual existence.

4. Benefits of Large-scale Operation: The joint stock company is the only form of business organisation which can provide capital for large-scale operations. It results in large-scale production consequently leading to increase in efficiency and reduction in the cost of operation. It further opens the scope for expansion.

5. Liquidity: The transferability of shares acts as an added incentive to investors as the shares of a public company can be traded easily in the stock exchange. The public can buy shares when they have money to invest and convert shares into cash when they need money.

6. Professional Management: Companies, because of the complex nature of theiractivities and large volume of business, require professional managers at every level of organisation. Because of the size of their business and the financial strength they can afford to appoint such managers. This leads to efficiency in management of their affairs.

7. Research and Development: A company generally invests a lot of money on research and development for improved processes of production, designing and innovating new products, improving quality of product, new ways of training to its staf , etc.

8. Tax Benefits: although the companies are required to pay tax at a high rate, in ef ect their tax burden is low as they enjoy many tax exemptions under Income Tax Act.

LIMITATIONS OF JOINT STOCK COMPANY

In spite of several merits of a joint stock company as discussed above, this form of business organisation also suffers from many limitations. The important limitations are given below:

1. Difficult to Form: The formation of a company involves compliance with a number of legal formalities under the companies Act and compliance with several other rules and regulations framed by the government from time to time.

2. Control by a Group: Theoretical y a company is supposed to be managed by trained and experienced Directors. But practical y this is not so in many cases. Most of the companies are managed by the Directors belonging to the same family. Since most of the shareholders are widely dispersed, they have indifferent at itude towards the management of the company. The shareholders holding majority of the shares take all decisions on behalf of the company. Thus, the democratic virtues of a company do not really exist in practice.

3. Excessive Government Control: A company is expected to comply with the provisions of several Acts. Non-compliance with these, invites heavy penalty. This af ects the smooth functioning of the companies.

4. Delay in Decision Making: A company has to fulfil certain procedural formalities before making certain decisions, as they require the approval of the Board of Directors and /or the General Body of shareholders. Such formalities are time consuming and therefore, some important decisions may be delayed.

5. Lack of Secrecy: It is difficult to maintain secrecy in many mat ers as they may require approval of board of directors and/or general body whose proceedings are usual y open to public.

6. Social abuses: A joint stock company is a large-scale business organization having huge resources. This provides a lot of power to them. Any misuse of such power creates unhealthy conditions in the society e.g. having monopoly of a particular business, industry or product; influencing politicians and government in get ing their work done; exploiting workers, consumers and investors, etc.

TYPES OF JOINT STOCK COMPANIES

We have a large variety of companies in our country, which differ in respect of their mode of incorporation, jurisdiction of functioning, nationality and limit on membership. Of these, the most important ones are those based on limits on membership, namely, (1) Private Company, and (2) Public Company. Let us learn more about these two types.

1. Private Company

Under the Companies Act, 2013, by ‘Private Company’ we mean a company, which has the following features –

(a) It cannot have more than 50 members.

(b) It cannot invite the public to purchase its shares and debentures through open

invitation. (c) It restricts the rights of the members to sel or transfer their shares.

(d) It must have a minimum paid-up share capital of one lakh rupees.

The private companies have to follow all these conditions noted above. It is compulsory for these companies to write "Private Limited' after their names. The ownership of these companies is confined only to wel -known selected persons. It requires minimum of two persons to start a private limited company.

2. Public Company

For starting a business on a large scale, one needs a huge capital, which, even fifty members of a private company cannot provide. In such a situation, a public company is suitable. A public company means a company, which is not a private company. A public company must have the following features.

(a)It can invite the public to subscribe to its shares and debentures by open invitation.

(b)A minimum of seven members is required to establish a public company. There is no limit on the maximum number of its members.

(c)There is no restriction on the transfer of shares i.e., the shareholders are free to sel their shares to the public.

(d)The public company must have a minimum paid up capital of five lakhs rupees.

A public company must write public limited or simply limited after its name. Reliance Industries Limited, Bajaj Auto Limited, Steel Authority of India Limited are examples of public companies.

CHOOSING THE RIGHT FORM OF ORGANISATION

We have noticed that no particular form of business organisation can meet all kinds of our requirements. Some may require more financial and managerial resources while others involve large risk. That is the reason why we find different forms of business organisations prevailing in our economy. So while selecting a form of business organisation, we analyse different factors and try to choose the most suitable form according to our financial and managerial capabilities. We wil now study those factors which may help us in selecting the right form of business organisation.

1. Ease of formation: A sole trader can commence and withdraw from business at any time at his own option. In partnership, mutual trust and faith is very much required. Company requires many legal formalities for its formation. Sole proprietorship is therefore the easiest to form.

2. Availability of Large Resources: One-man business is the best in the world if the owner has enough resources and ability to manage. This statement showsthat a single person is unable to undertake big business mainly because of limited resources and managerial ability. In partnership also the financial resources of partners are limited. Therefore, only a company can raise enough capital and hire expert knowledge required for the management of a big business.

3. Liability or Risk: We know that liability of members is unlimited both in sole proprietorship and partnership and limited in case of a company and cooperative societies. Since members hesitate to undertake big risk, they prefer to invest in a company.

4. Stability: Stability is essential for the success of any business. The existence of a company and cooperative society does not depend on the health and wealth of its members. Sole proprietorship and partnership forms are dissolved but company form of an organisation continues irrespective of the death or insolvency of any of its members.

5. Flexibility: An ideal form of business must have flexibility in operations. Decisions must be taken quickly and implemented promptly for its functioning. Any rigidity in its functioning wil not be beneficial for the survival and growth of a business. A company enjoys better flexibility whenever more finances are 19 PGT Commerce In-service Training Module - 2 2016 - 17 required. It can raise more capital and include more members whenever needed. In a partnership, the number of members at any time cannot exceed 20. In sole proprietorship there is only one owner and availability of finances is also limited. But flexibility in operations is maximum in sole proprietorship. He does not require approval of other members as in partnership or compliance with the provisions of the Act as in a company. Hence, the change in the nature of business or its operations is easiest in the case of sole proprietorship.

6. Secrecy: Sole trader is the master of his entire business. He does not need to share his secrets with anyone. Partnership is organised on the basis of mutual agency and therefore all the partners have the right to know everything about the business. A company is required to file a number of documents to various Government Agencies (Registrar of Companies, SEBI & Stock Exchange) and publish its annual reports. Therefore secrecy is the least in case of a company in comparison to all other forms of Business Organisation

7. Extent of State Control: While it is not possible altogether to avoid compliance with governmental regulations the entrepreneur wil always like to choose that form of business organisation which has minimum government interference. A company has to fulfil many legal formalities before it can commence its business. Even after the formation, it has to comply with various legal provisions. In sole proprietorship and partnership, the government control is comparatively less.

Let's Sum Up

On the basis of ownership and management there are different forms of business organisation. They are Sole Proprietorship, Partnership, Joint Hindu Family, Cooperative Society and Joint Stock Company.

• **Sole proprietorship** refers to a form of business organisation where a single individual owns and manages the business. He/she takes the profits and bears the losses. Merits of this form of business organisation include, easy to form and windup, quick decision and prompt action, direct motivation; flexibility in operation. The businessman himself can give personal touch to each and every mat er of the business that enables him to maintain the secrets of his business. In spite of all these merits, this form also suf ers from the limitations of limited resources, lack of continuity, unlimited liability of the owner, limited managerial expertise. This form is not suitable for large-scale operations.

• **Partnership** is a form of business organisation in which two or more competent persons join hands to carry on any lawful business after entering into an agreement to 20 PGT Commerce In-service Training Module - 2 2016 - 17 share the profit and loss of the business. A partnership firm is easy to form and also flexible in its operation. It pools resources from the partners, makes their optimum utilisation by taking better decisions. It protects the interest of each and every partner and gets benefit out of the specialised knowledge and Skills of individual partner. Since partners share the profits and losses they show keen interest in the affairs of the business. The major limitations of partnership form of business organisation are: unlimited liability, instability, limited capital, non-transferability of share and lack of harmony among the partners.

•In partnership firm we find different types of partners like Active partners, Sleeping partners, Nominal partners, Partners in profits, Limited partners and General partners. Partners by Estoppel and Partners by holding out.

• **Joint Hindu Family** form of business organisation is governed by Hindu Law. The members of the Hindu undivided family jointly own the business and the eldest member called Karta manages the business in the best possible manner. Every member called co-parcener gets an assured share in profit irrespective of their participation. The liability of co-parceners except the Karta is limited. The death or insolvency of any member does not af ect the continuity of the business. This form of business organisation too suf ers from certain limitations like limited resources, lack of motivation, scope for misuse of power by Karta and instability.

• **Cooperative society** is a voluntary association of persons who work together to promote their economic interest. It works on the principle of self-help and mutual help. The membership of cooperative societies is voluntary and open to all . It has separate legal existence and is democratical y managed. The cooperative societies are easy to form and have a stable life. They get assistance from the government in the form of loan, grants and subsidies. The government also provides tax concession. The liability of the members is limited up to their capital contribution. In spite of all these advantages, it also suf ers from various limitations like insufficient capital, lack of managerial expertise. There is also lack of motivation in members due to absence of direct reward for individual ef orts.

• According to the need of the people we find different types of cooperative societies in our country. Some of the important types are – Consumers cooperative societies, Producers' cooperative societies, Marketing cooperative societies, Housing cooperative societies, Farming cooperative societies and credit cooperative societies.

A joint stock company is an artificial person, having a separate legal entity, with a perpetual succession.

• Merits of Joint Stock Company: A joint stock company can arrange large resources. Its members enjoy the benefits of limited liability. It has perpetual existence. The benefits of 21 PGT Commerce In-service Training Module - 2 2016 - 17 large scale business operation can only be derived from this form of organization. Its shares are easily transferable. It derives the benefit of professional management in its operation.

• Limitations of Joint Stock Company: The formation of a joint stock company involves compliance with a number of legal formalities. It suffers from the limitations of excessive government control. It is very dif icult to maintain secrecy in the business. All important decisions require the approval of Board of Directors or General body of the shareholders. So it takes more time in taking certain decisions. The joint stock companies are practical y managed by a specific group of people. The shareholders, who are scat ered all over the country, generally do not take keen interest in each and every mat er of their company

• Choosing the right form of organisation: The following factors may be considered while choosing a suitable form of business organization: (a) Ease of formation; (b)Availability of resources; (c) Liability or risk; (d) Stability; (e) Flexibility; (f) Secrecy;(g) Extent of state control

Check your progress

1. Define sole proprietorship.
2. Distinguish between partnership and sole proprietorship business on the basis of membership.
3. What is meant by 'partnership deed'? Is it essential for partnership?
4. Describe any four different types of partners.
5. Who is a partner by estoppel?
6. Who is 'Partner by holding out'?
7. Explain any two limitations of partnership form of business organisation.
8. State the meaning of the term 'Coparcener'.
9. What is a Joint Hindu Family business?
10. What is meant by the term 'share'?
11. How do you identify a public company and a private company just by seeing their names?
12. State the different types of cooperative societies that exist in India.
13. Give the definition of cooperative society as per the Indian Cooperative Societies Act 1912.
14. differentiate between Sole Proprietorship and Partnership firm.
15. State the meaning of the term 'Company' as per the Companies Act 2013.
16. differentiate between Partnership firm and Co-operative Society.
17. differentiate between Partnership firm and Joint Stock Company.
18. differentiate between Co-operative Society and Joint Stock Company.
19. In which Act the maximum number of partners in a partnership firm is mentioned?
20. differentiate between Private Company and Public Company.

UNIT-I

Risks and Rewards of Business and Insurance

Abstract

Business is ful of uncertainties. Uncertainties can be of different forms like loss due to change in fashion; fal in market price; goods produced may be destroyed by fire, storm, cyclone, theft etc. Thus, while running a business enterprise, there is an element of risk. Business risk means chance of loss due to uncertain events in future.

Businesspersons are ready to bear these risks because they want to earn profit. In view of the above we can say that in expectation of profit they bear business risks. In this unit we wil study about the role of profit in business, various types of business risks and their causes. All of us have seen shops in the market. In these shops goods are stored for sale. We know about transportation viz: land, water and air which carry goods from one place to another.

al these involve lot of money and there is always a risk of loss in transit. The damage may be due to accidents like fire, natural calamities or even riot or theft. Similarly in factories the machines may break down causing heavy loss. During transportation the goods may get damaged or destroyed due to accident. Under all these circumstances there is always a loss incurred by the businessman. Not only the assets or properties of businessman, he himself is also not out of danger on his day- to-day life. He may suffer any disease or face accident which may cause a great loss to his livelihood. Can these risks be avoided or minimized? Is there anything to take care of these risks? Let us learn all about it in this module.

Key Terms

Business Risk

Insurance

Uncertainties

Compensation

Insurer

Insured

Endowment Policy

Life Insurance

Fire Insurance

Learning Outcomes

After studying this Unit, Learners wil be able to:

- state the Role of Profit in business;
- discuss the relation between risk and profit;
- explain various types of risks of business;
- identify the causes of business risks;
- explain the nature of business risks;
- define insurance;
- explain the importance of insurance;
- identify different types of insurance;
- Describe the salient features of life insurance, fire insurance, marine insuranceand other types of insurance; and
- State the principles applicable to insurance contract.

Role of Profit in Business

Profit plays an important role in business. following points indicate the role of profit in business:

1. Survival: Profit helps an organization to replace old assets and increases the capacity of an organization to survive.

2. Future growth and expansion: Profit earned can be utilized for expansion purpose. Entry in new areas helps an enterprise to grow and diversify.

3. Incentive: Profit is an incentive for businessmen who put hard work. Profit motivates the businessmen to put maximum ef orts.

4. Prestige: Profit making organizations can af ord to give higher wages/salaries and other facilities to their employees. This can retain employees and at ract highly competent persons to join the enterprise. So profit making concern enjoys goodwil in the society.

5. Achievement of Goals: Only a profit making concern can achieve the goals of an enterprise because achievements of economic objectives require expenditure.

6. Measure of Efficiency: The success of an organization can be evaluated by looking at its profit. So profit is an index of success in business. It measures the efficiency of business.

7. Means of Livelihood to Businessmen: Profit is a regular income to the family of business persons.

Business Risks

Business is ful of uncertainties. Uncertainties can be of different forms like loss due to change in fashion; fal in market price; goods produced may be destroyed by fire, storm, cyclone, theft etc. Thus, while running a business enterprise, there is an element of risk. Business risk means chance of loss due to uncertain events in future.

Nature of Business Risk

1. Uncertainty: Business risks are due to uncertainty of the future course of action. A natural calamity such as flood, earthquake etc. result is loss. Loss may also arise due to human causes like strike, lockouts, accidents, theft, bad-debts etc. There are other uncertainties such as competition, technological changes, price fal etc.

2. Profit is the Reward for Risk: A business concern which is wil ing to take risk earns handsome profits. Heavy risk results in higher profits.

3. Difficult to Measure: A businessman may anticipate some risks. He cannot predict all the risks which wil occur in future. Therefore, risk cannot be measured accurately.

4. Essential Element of Business: Business activities cannot be conducted without some element of risk. Risk bearing is an essential element of business.

5. Variability: According to the nature and size of business, the degree of risk varies. If the amount invested is high, there wil be high degree of risk. The degree of risk varies with time and competition.

Causes of Business Risks

1. Natural Causes: Fire, flood, storm, cyclone, earthquake, famine, lightning, snowfal , tide etc. result in loss of life, property and income. Therefore, natural causes are beyond the control of business.

2. Economic Causes: It refers to change in market conditions. Economic causes can be in the form of fluctuation in demand, fluctuation in price, availability of cheap substitutes, competing business firms etc. 3. Political Causes: Fal of government may change license policy and tax policy. This may result in loss to the business. Import and export restrictions, high taxes, rise in interest rate on borrowings etc. may cause loss to the business. Political causes refer to changes in government policies and laws.

4. Human Causes: Inefficient management and carelessness of employee may result in loss. Workers may damage machines. They may involve in strike, lockout etc. which may also result in loss. If the management fail in estimating demand for products, loss may arise. Uncertainties caused by human actions e.g. forgery, misappropriation of cash, theft of goods, riots, wars, etc. can also result in loss.

5. Physical and Technical Causes: Change in technology may make the machines obsolete before their expected life. Mechanical failures arise due to leakage of gas, bursting of a boiler etc. Value of assets may be reduced due to loss in weight, vaporisation etc. Another kind of physical cause is the loss of goods in transit.

Insurance

Nature of Business Risks

We have already learnt about the business risks and uncertainties and now we have to know the nature of business risks.

Earning of profit is the most important objective of every business because without profit our capital wil get reduced and may be totally lost. So every businessperson wil do his/her best to manage his/her business efficiently. Sometimes she/he may find that sale of goods produced in his/her factory is declining.

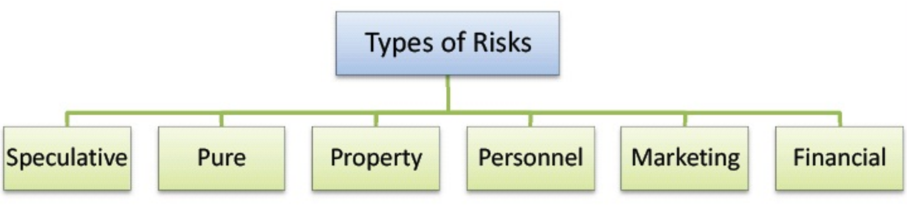
That is a warning signal, which may also result in loss of income or profit. Goods may be lost in course of transportation. There may be accidental fire in the godown; workers of the factory may go on strike. We may not be able to anticipate or control some of these possibilities. This is the concept of risk. Risk is the possibility of loss or damage due to factors over which the businessman has lit le or no control.

It shows that the Insurance is spreading the risk. Therefore image is meaningful and suitable.

All business activities are subject to uncertain events or happenings and may suffer loss or damage. Timely precaution can be taken to avoid some of the losses. But certain losses and damages have either to be borne by the businessman himself/herself, or if possible, shared with others.

The possibility of loss or damage can be divided into two broad categories: uncertainties and risks. Uncertainties are the events, which cannot be foreseen. But risks can be anticipated in the light of past experience. The chances of fire in the factory or godown depend upon precautions taken to prevent its occurrence, or having necessary preparedness to keep the resulting loss at a minimum level. So is the case with loss or damage by theft or accidents.

There are also risks, which have a significant place in business. While goods are transported from place to place, there may be accidents causing, damage or loss of goods. Trains may be derailed, bridges may col apse, or airplane may crash due to engine trouble. Trucks may be looted on their way to another city. Damage may be caused to goods sent by ship at the time of loading or unloading at sea ports. Can such damages or losses be shared with any other party? Let us note how these can be shared by means of insurance.



Speculative Risk: Risks relating to business judgment based on speculation. Change in fashion, govt. policy etc.

Pure Risk: Risks where the chance of loss is predictable.

Property Risk: Related to Loss of property.

Personnel Risk: Related to life or health of the people.

Financial Risk: Related to financial transactions of the business.

Marketing Risk: Risk associated with marketing of goods.

What is meant by Insurance?

Simply speaking, insurance is the means by which risks of loss or damage can be shifted to another party called the insurers on the payment of a charge known as premium. The party whose risk is shifted to the insurer is known as the insured. Obviously insurer is generally an organization (Insurance Company), which is willing to share the loss or damage and it is also qualified to do so.

Insurance is a contract between the insurer and insured whereby the insurer undertakes to pay the insured a fixed amount, in exchange for a fixed sum known as premium, on the happening of a certain event (like at a certain age or on death), or compensate the actual loss when it takes place, due to the risk insured.

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If we think about the basis of insurance, we wil realize that it is a form of co-operation through which all the insured, which are subject to a risk, pay premium and only one or few among them who actual y suf er the loss or damage is/are compensated. Actual y, the number of parties exposed to a risk is very large and only a few of them might actual y suf er loss during a certain period. The insurer (company) acts as an agency to spread the actual loss suf ered by a few insured parties among a large number of parties.

Importance of Insurance

To appreciate the importance of insurance we have to discuss the benefits that we derive from it.

1. Spreading the Risk

Insurance serves as a useful means of spreading the effects of personal as wel as business risks by way of loss or damage among many. Individuals who pay premium periodical y out of current income can look forward to an assurance of receiving a fixed amount on retirement or his family being secured in the event of his death. Businessmen also pay premium for insurance of risk of loss without constant worry about the possibility of loss or damage.

Insurance is spreading the Risk

If in a city of 1 lakh houses & shops, there are about 1,000 thefts every year, though some particular 1,000 people are af ected by the theft, all others 99,000 would fear theft, and would like some solution to this problem.

We presume that every shopkeeper where thefts have occurred wil get a compensation of 10,000 which means:

Number of shops = 1,00,000

No. of shops af ected by Theft = 1,000

Each shop wil get = 10,000

Total outgo = 10,000 * 1,000= 1,00,00,000

Contribution by all shops = 1,00,00,000/1,00,000= 100 per shop

Thus with a smal amount of 100 each shopkeepers i.e. 1,00,000 shopkeepers feel assured for payment of 10,000 each in case of theft in their shop. And if that individual had to provide for himself, by himself then the entire 10,000 would have to be arranged by the unfortunate shopkeepers himself.

***Thus losses are spread among the large number of persons which is the mechanism of the insurance system.**

But, is this smal sum of 100 really the premium?

Answer to this question is - No but Not the least.

Another example

Suppose in a year,

Total population = 1,00,000

Death =200

Disabilities =800

Death payment, say = 1 lakh

Disability payment, say = 50,000

Death claims amount for the year = 2,00,00,000 (200 X 1 lakh) – (a)

Disability amount for the year = 4,00,00,000 (800 X 50,000) – (b)

Total outgo (expected) (a + b) = 6,00,00,000 (6 crores)

Therefore, minimum contribution which 1 lakh persons should have made to meet the claims 6 crores / 1 Lakh = 600 per year

Thus with a smal amount of 600 each, 1 lakh people feel assured for payment of 1 lakh each in case of death, and 50,000 in case of disablement.

And if that individual had to provide for himself, by himself then the entire 1 lakh or 50,000 would have to be arranged by the unfortunate person himself.

But, is this smal sum of 600 really the premium?

No, the above calculated premium 100 or 600 per person is not real premium.

We wil have to add all costs & expenses of management (which go on decreasing in proportion of large-ness of the number of people contributing or buying the insurance policy). **(Let us assume it to be say X)**

Then, add provision of profit to the entrepreneur, shareholders since everybody opens his shop for profits, for gains, and not as a charitable house, (or else the shop wil close). **(Let it be say Y)**

Further there has to be the provision of a standing fund /reserve to of -set large natural calamities (Like floods, earthquakes, volcanic eruptions, or large-scale accidents like Concorde Airplane crashing or Sahara air bus going into flames .**Disasters like Gujarat Earthquake or loss to life, property and business in 11th Septmeber'2001 terrorist attack – Manhattan or Pentagon) is an apt example of the same**. (Let it be say Z)

Then the total premium comes to [100+X+Y+Z] or

Then the total premium comes to [600+X+Y+Z]

The above is a very rough and crude example of arriving at cost of an Insurance product.

Experts called actuaries specialize in design and right pricing of Insurance products.

*The method explained above of sharing losses of a few by many is the basis or

core philosophy of insurance

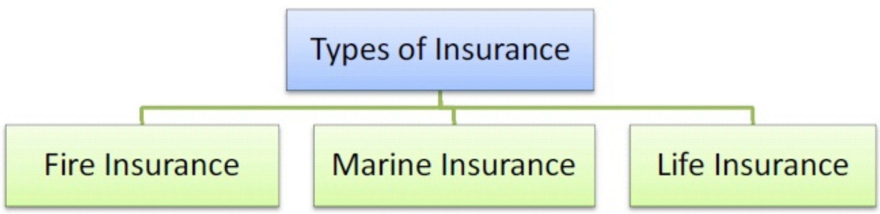
2. Sense of Security
Insurance plays a significant role particularly in view of the large-scale production and distribution of goods in national and international market. It is an aid to both trading and industrial enterprises, which involve huge investments in properties and plants as wel as inventories of raw materials, components and finished goods. The members of business community feel secured by means of insurance as they get assurance that by contributing a token amount they wil be compensated against a loss that may take place in future.

3. Capital Formation
From the national economic point of view, insurance enables savings of individuals to accumulate with the insurance companies by way of premium received. These funds are invested in securities issued by big companies as wel as Government.

4. Motivation for Saving
Individuals who insure their lives to cover the risks of old age and death are induced to save a part of their current income, which is by itself of great importance.

5. Source of Employment
Insurance is also a source of employment for the people. The people get employed directly in its of ices spread over the country and it also provides opportunities to the people to earn their livelihood by working as agent of the insurance companies.

Figure: Types of Insurance



Insurance, which is based on a contract, may be broadly classified into the following type-.

1. Life Insurance

2. Fire Insurance

3. Marine Insurance, and

4. Other types such as burglary insurance, motor vehicle insurance, etc.

Until recently Life Insurance Corporation of India (LIC) and General Insurance Corporation of India with its subsidiaries happened to be the only organizations engaged in life and general insurance business in India. Now a number of other private companies have entered this service sector. Let us consider the salient features of each of these types.

1. Life Insurance

Why people get their life insured? If somebodies depend on you, life insurance can replace that income for them if you die. The most commonly recognized case of this is parents with young children. However, it can also apply to couples in which the survivor would be financial y stricken by the income lost through the death of a spouse.

Can life be insured?

Life cannot be insured but assured and future of dependents can be secured through the life insurance.

Is it appropriate to use 'Insurance' here instead of Assurance?

Yes , because 'Assurance' is appropriate word in case of Life insurance. Let's see the difference between 'Assurance' and 'Insurance'.

What is the difference between Insurance and Assurance?

Insurance policy refers to protection against an event that may happen whereas assurance policy refers to protection against an event that must happen. This means that insurance policy is taken to prevent a risk or provide cover against a risk while assurance policy is taken against an event that is definite.

Assurance policies are undertaken by people knowing that death is certain. They keep on paying premiums knowing that their heirs wil receive a big amount whenever they die. Insurance Company issuing assurance policy is assured of the death of the insured person and also that it has to pay the amount whenever the insured person dies. Because of this assurance factor, such a policy is called assurance policy.

A contract of life insurance (also known as 'life assurance') is a contract whereby the in surer undertakes to pay a certain sum either on the death of the insured or on the e xpiry of a certain number of years. In return, the insured agrees to pay an amount as premium either in a lump sum or in periodical instal ments, annual y or half- yearly. The risk insured against in this case is certain to happen. Hence, life in surance is also referred to as life assurance.

The written form of contract is known as life insurance policy. It provides for the payment of a fixed sum to the insured either on a fixed date or on the happening of an event, which is certain. Businessmen can provide for life insurance of all their employees by way of group insurance. It also develops loyalty among employees and can be used as a security for raising loans.

There are two basic types of life assurance policies (a) Whole-life policy, and (b) Endowment Policy. A whole life policy runs for the whole life of the insured and premium is payable all along. The sum assured becomes due for payment to the heirs of the insured only after his death. An endowment policy on the other hand, runs for a limited period or up to a certain age of the insured. The sum assured becomes due for payment at the end of the specified period or on the death of the insured, if it occurs earlier.

(ii) Fire Insurance

A contract of fire insurance is a contract whereby the insurer, on payment of premium by the insured, undertakes to compensate the insured for the loss or damage suffered by reason of certain defined subject mat er being damaged or destroyed by fire. It is a contract of indemnity, that is, the insured cannot claim anything more than the value of property lost or damaged by fire or the amount of policy, whichever is lower.

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The claim for loss by fire is payable subject to two conditions, viz; (a) there must have been actual fire; and (b) fire must have been accidental, not intentional; the cause of fire being immaterial. The basic principle applied with regard to claim is the principle of indemnity. The insured is entitled to be compensated for the amount of actual loss suffered subject to a maximum amount for which he had taken the policy. He cannot make a profit through insurance.

(iii) Marine Insurance

Marine insurance is an agreement (contract) by which the insurance company (also known as underwriter) agrees to indemnify the owner of a ship or cargo against risks, which are incidental to marine adventures. It also includes insurance of the risk of loss of freight due on the cargo. Marine insurance that covers the risk of loss of cargo by storm is known as cargo insurance. The owner of the ship may insure it against loss on account of perils of the sea.

When the ship is the subject matter of insurance, it is known as hull insurance. Further, where freight is payable by the owner of cargo on safe delivery at the port of destination, the shipping company may insure the risk of loss of freight if the cargo is damaged or lost. Such a marine insurance is known as freight insurance. All marine insurance contracts are contracts of indemnity.

The followings are the different types of marine insurance policies:

(a) Time Policy – This policy insures the subject matter for specified period of time, usually for one year. It is generally used for hull insurance or for cargo when small quantities are insured.

(b) Voyage Policy - This is intended for a particular voyage, without any consideration for time. It is used mostly for cargo insurance.

(c) Mixed Policy – Under this policy the subject matter (hull, for example) is insured on a particular voyage for a specified period of time. Thus, a ship may be insured for a voyage between Mumbai and Colombo for a period of 6 months under a mixed policy.

(d) Floating Policy - Under this policy, a cargo policy may be taken for a round sum and whenever some cargo is shipped the insurance company declares its value and the total value of the policy are reduced by that amount. Such shipments may continue until the total value of the policy is exhausted.

(iv) Other types of Insurance

Apart from life, fire and marine insurance, general insurance companies can insure a variety of other risks through different policies. Some of these risks and the different policies are outlined below.

(a) **Motor vehicles Insurance:** Insurance of all types of motor vehicles- passenger cars, vans, commercial vehicles, motor cycles, scooters, etc., covers the risks of damage of the vehicle by accident or loss by theft, as also risks of liability arising out of injury or death of third party involved in an accident. Third party risk insurance is compulsory under the Motor Vehicles Act.

(b) **Burglary Insurance:** Under this insurance the insurance company undertakes to indemnify the insured against losses from burglary i.e., loss of moveable goods by robbery and theft by breaking the house.

(c) Fidelity Insurance: As a protection against the risks of loss on account of embezzlement or defalcation of cash or misappropriation of goods by employees, businessmen may get policies 36PGT Commerce In-service Training Module - 2 2016 - 17 issued covering the risks of loss on account of fraud and dishonesty on the part of employees handling cash or in charge of stores. This is called fidelity insurance policy. The employees may also be required to sign a fidelity guarantee Bond.

(d)Personal accident and sickness Insurance: These are policies which can be taken out against death or disability in special circumstances, for example holidays, flights, etc.

(e) Liability Insurance: This type of policy covers the risk of liability for the injury or death of someone else. These are two main forms as (i) Employers liability- covers the employers legal liability for the safety of each employee.(ii) Public liability- covers the liability of individuals and business for members of public visiting their premises.

(f) Property Insurance: Covers a wide variety of items from goods in transit or in store to building or contents. It applies to both the business persons and the private householders.

Difference between Fire, Marine and Life Insurance

S.No.	Basis of Difference	Fire Insurance	Marine Insurance	Life Insurance
1.	**Compensation**	Amount insured or Actual loss whichever is less is given as compensation.	Purchase price of goods and 10-15 percent profit is given as compensation.	No loss is compensable only specific amount is paid.
2.	**Insurable Interest**	Insurable interest must exist both at the time of taking policy as well as the time of loss.	Insurable interest must exist at the time of loss.	Insurable interest must exist at the time of taking policy.
3.	**Assignment of policy**	No Assignment without permission of Insurance Company.	No Assignment without permission of Insurance Company.	No Assignment is done.
4.	**Nature of Risk**	Uncertain	Uncertain.	Certain but the time is uncertain.
5.	**Period**	Normally for one year	Normally for one year.	It is taken for a long term.
6.	**Premium**	Premium depends upon the amount insured. More the amount insured more will be premium	Premium depends upon nature of perils.	Premium depends upon the Age of the insured and term of policy.
7.	**Object**	To cover the risk of fire.	To cover the sea perils.	Protection and Investment.
8.	**Surrender**	Cannot be surrendered before expiry.	Cannot be surrendered before expiry.	Can be surrendered before maturity.

Principles of Insurance

Why there is a need of principles of insurance?

The main motive of insurance is cooperation. Insurance is defined as the equitable transfer of risk of loss from one entity to another, in exchange for a premium. Therefore some fundamental rules/principles are implied in the contract of insurance. These principles are known as principles of Insurance.

There are certain principles that may apply to the contracts of insurance between insurer and insured, which are as follows.

i. Utmost good faith

Insurance contracts are the contract of mutual trust and confidence. Both parties to the contract i.e., the insurer and the insured must disclose all relevant information to each other.

The insurer must honour all the promises in their policy, intentional withholding of information invalidates the contract. For example, while entering into a contract of life insurance, the insured must declare to the insurance company if he is suffering from any disease that may be life threatening.

iii. Insurable interest

For example, a man can take life insurance policy on the name of his wife and if later they get divorced this wil not affect the insurance contract because the man had insurable interest in the life of his wife at the time of entering into the contract.

It means financial or pecuniary interest in the subject matter of insurance, or we can say that existence of a thing must provide the benefits to a person and destruction of a thing may provide a loss. A person has insurable interest in the property or life insured if he stands to gain from its existence or loose financial y from its damage or destruction. In case of life insurance, a person taking the policy must have insurable interest at the time of taking the policy.

In case of marine insurance insurable interest must exist at the time of loss or damage to the property. In contract of fire insurance, it must exist both at the time of taking the policy as wel as at the time of loss or damage to the property.

iii. Indemnity

The word ***Indemnity*** means to restore someone to the same position that he/she was in before the event concerned took place.

This principle is applicable to the fire and marine insurance. It is not applicable to life insurance, because the loss of life cannot be restored. The purpose of this principle is that the insured is not allowed to make any profit from the insurance contract on the happening of the event that is insured against. Compensation is paid on the basis of amount of actual loss or the sum insured, whichever is less.

iv. Contribution

The same subject mat er may be insured with more than one insurer. In such a case, the insurance claim to be paid to the insured must be shared or contributed by all insurers.

v. Subrogation

Study the following example,

Suppose goods worth 90,000 are partial y destroyed by fire and the insurance company pays the compensation to the insured.

Can the insurance company take even these partial y destroyed goods and sel them in the market?

Yes

In the contract of insurance subrogation means that after the insurer has compensated the insured, the insurer gets all the rights of the insured with regard to the subject mat er of the insurance.

vi. Mitigation

In case of a mishap the insured must take all possible steps to reduce or mitigate the loss or damage to the subject mat er of insurance. This principle ensures that the insured does not become negligent about the safety of the subject mat er after taking an insurance policy. The insured is expected to act in a manner as if the subject mat er has not been insured.

vii. Causa-proxima (nearest cause)

A ship carrying fruits was insured against losses arising from accident. The ship reached the port safely and there was a delay in unloading the fruits from the ship.

As a result the fruits got spoilt.

The insurer did not pay any compensation for the loss because the proximate cause of loss was delay in unloading and not any accident during voyage.

According to this principle the insured can claim compensation for a loss only if it caused by the risk insured against. The risk insured should be nearest cause (not a remote cause) for the loss. Then only the insurance company is liable to pay the compensation.

Exemplar Cases related to Life Insurance

Case 1. Ombudsman: Bhubaneswar

Brief facts of the case

Insurer all eging suppression of material fact concerning health and pre-existing il nesses by the Life Assured

Findings of the case

Insurer could not prove beyond doubt that the Life assured suffered from serious il nesses before taking the policy.

Decision

Insurer was directed to settle the claim within one month from the receipt of the consent let er.

Case 2. Ombudsman: Ahmedabad

Brief facts of the case

While taking the policy the life assured had informed in great detail the state of his health and habits due to which several Special Reports were called for and the proposal was accepted with extra premium.

Findings of the case

The life assured died within ten months from the date of proposal. The claim was repudiated on the grounds of suppression of material facts on the basis of certificate of treatment, prescription, letters of doctors and hospital. It was observed that all the diagnosis/treatment commenced after 7 days from the date of acceptance of risk. All the documents proved that the deceased was not aware of his ailment at the time of taking the proposal.

Decision

The respondent (the insurer) was directed to pay the ful claim amount.

Case 3. Ombudsman: Bhopal

Brief facts of the case

The deceased life assured had produced voter I.D Card as age proof and the agent filled up the proposal form. It was an early claim. Date of Birth mentioned was 1-1-1950. His actual Date of Birth was 1-8-1943 and was working as postman in postal department. Had he declared his correct age, the proposal would not have been accepted. He had deliberately understated his age.

Findings of the case

The deceased was a government servant and deliberately understated his age to defraud the respondent (Insurer), in order to accept the proposal and there by misled the respondent in taking proper underwriting decision.

Decision

The decision taken by the respondent (Insurer) in repudiating the claim is just and fair and hence does not require any interference. Therefore the complaint is dismissed without any relief.

Case 4. Ombudsman: Chandigarh

Brief facts of the case

Insurer all eged that it was a case of suicide as per complaint of the father of the diseased to police; hence suicide clause applies and nothing is payable. The claim was repudiated.

Findings of the case

The father was not present at the scene of the death. No suicide note was found. Chemical analysis did not find any poison in the body. Post Mortem report also did not find any poison in the body. The report of Panel of doctors did not confirm that death was due to consumption of poison.

Decision

That the sum assured of 5 lakhs along with accrued bonus, if any, be paid to the nominee/complainant.

Case 5. Ombudsman: Chennai

Brief facts of the case

The insurer all eging non-disclosure of material fact of suf ering from Acute Lymphoblastic Leukemia (ALL) with relapse with refractory disease in the proposal form and hence the claim is repudiated.

Findings of the case

The deceased had been undergoing treatment for ALL since 2000 and he underwent Orchiectomy for relapse in 2003. Did not disclose this in proposal form submit ed in Dec 2005

Decision

There is clear medical evidence to show that the deceased was suffering from Leukemia wel before signing the application for insurance. Hence the complaint is dismissed and the decision of the insurer was upheld.

Some interesting Cases of General Insurance

Case 1

Motor Vehicle Insurance - An Interesting Case

Recently, an interesting case came up in the news highlighting a big lacuna in the car insurance claim process. It turns out that an insured car was stolen and as per the usual process, the claimant processed a claim. However, the insurance company kept delaying the disbursement of the claim in the faint hope of car getting recovered in sometime soon. Meanwhile, the frustrated claimant, a resident of Kolkata, brought a new car. After 15 months, police recovered the lost car in a dilapidated condition. Now, the insurance company used this as an excuse to reject the claim flaring a debate.

Is the insurance company justified in rejecting the claim?

In today's life, car is a necessity and delaying the claim by 15 months is not warranted. A person would need a car almost immediately. On the other hand, it seems that the insurance company was knowingly delaying the process in the faint hope of recovering the car and get ing excused from paying up. To top it up, the recovered car is in non–working condition and thus useless for the claimant.

The woes of the claimant are never-ending in this situation. Firstly, his car gets stolen. Secondly, he keeps running after the insurance company to process his claims. Thirdly, his claim is indefinitely delayed and he has to purchase a new car without any financial help. Fourthly, his claim gets rejected and his broken, non-working and useless car is given back. Here, the claimant is in complete loss.

This is a clear case of bluf ing by the insurance company. It is such practices by the insurance provider that tarnishes a buyer's trust and makes insurance buying an unpopular choice.

Set le the claim within a stipulated time to keep the real purpose of buying a policy intact. Reduce buyer's harassment by dealing with transparency and honesty. The idea should not be to delay the claim but to do the right thing and sympathize with the claimant too. It is for timely financial assistance that a buyer pays premium and stays with an insurance company.

Case 2

Marine Insurance

A line of designer clothing manufactured in Asia was shipped to an Australian wholesaler just in time for its seasonal release. However, a fresh water leak from a hole in one of the sea containers carrying clothing caused a humidity condition within the container. While the clothing was not directly damaged by the water, the moisture allowed a mildew odour to af ect that part of the shipment.

When delivered to the distribution centre, the clothes, while physical y undamaged, had a smel that would deter any would-be buyer, also affecting the other clothes on the store shelves. Not all the clothes were affected, perhaps only particular sizes, but the clothes were not suitable for sel ing. The entire clothing line and its launch were threatened.

The company lodged a claim under their Marine Cargo policy.

The Insurance Company's Claims Team, in conjunction with local appointed experts, implemented an action plan that utilised a cut ing edge ozone treatment process to eliminate the mildew odour and recondition the clothing making it once again saleable to the Australian buyer.

This solution meant that the insured reclaimed the damaged clothing and prevented the larger issue for the insured. The entire order could have been cancel ed due to this incident, jeopardising the relationship between the designer and the retailer had the clothing line not been available for sale at the outset of the new season.

Let's Sum Up

Risk is the possibility of loss or damage due to causes over which we have lit le or no control. All business activities have to face the risks of loss or damage due to uncertain events or happenings.

Insurance is a means by which the risks of loss or damage can be shifted to another party (the insurer) on payment of a charge known as premium. The party whose risk is shifted to the insurer is known as the insured.

Insurance is based on a contract between the insurer and insured whereby the insurer, in exchange for a fixed sum (premium), undertakes to pay the insured a specified amount on the happening of a certain event (like the insured reaching old age), or pay the amount of actual loss when it takes place due to the risk insured.

Importance of Insurance: Insurance is a simple means of sharing the burden of loss or damage among many people. It plays a significant role in business in view of the large- scale production and distribution of goods in national and international markets. It is an aid to both commercial and industrial enterprises. It enables the accumulated premium receive to be invested insecurities which in turn are utilised for national development. Insurance is also a source of employment for many people.

Types: Insurance as a service activity may be classified into four broad types:

Life Insurance: Whole-life policy, Endowment policy

Fire Insurance: Time policy

Marine Insurance: Voyage policy, Mixed policy, Floating policy

Others: Motor-vehicles insurance, Burglary insurance, Fidelity insurance, Personal accident and sickness Insurance, Liability Insurance, Property Insurance.

- Profit is needed for survival, future growth and expansion, creating prestige, achieving goals and to measure the efficiency of business firm.
- Business risk means chance of loss due to happening of uncertain events in future.
- Business risk is uncertain, dif icult to measure, variable and an essential element of business.
- Business risks arise due to natural, economic, political, human, physical and technical causes.

Check Your Progress

1. Identify the causes of business risk in the following causes:

i. X Ltd. suf ered a loss due to bursting of boiler.

a) Natural Cause

b) Political Cause

c) Physical Cause

d) Economic Cause

ii.Auditor identified misappropriation of cash by a group of workers in Y Ltd.

a) Natural Cause

b) Human Cause

c) Physical Cause

d) Political Cause

iii. Suraksha Ltd. suffered a loss due to tsunami

a) Natural Cause

b) Human Cause

c) Economic Cause

d) Political Cause

Ans. i. (c)

ii. (b)

iii. (a)

Frequently Asked Questions

2. Which of the following statements are true and which are false (Tick)?

(i) The possibility of loss or damage to goods or human beings is known as

risk. (T/F)

(ii) Change of fashion is a personnel risk. (T/F)

(iii) Losses caused by uncertain events of insured goods have to be borne by businessmen themselves. (T/F)

(iv) Some risks can be taken care of by precautions such as risk of breakdown of machinery. (T/F)

(v) Insurance is the means of shifting risks of loss to a party wil ing and qualified to share the loss. (T/F)

(vi) The amount paid by the insured to the insurer is known as premium. (T/F)

3. Fil in the blanks with suitable words given in brackets.

(i) Insurance is a means of spreading the ________ of a few among many. (Loss, expense)

(ii) The members of the business community feel ________ because of insurance. (Secured, unsecured)

(iii) Insurance companies invest their funds in corporate and Government ______ (loans, securities)

(iv) Insurance is an aid to ________ as wel as commerce. (Industry, trade)

4. Which of the following statements are true and which are false?

(i) Marine insurance contracts are ordinary contracts while life insurance is a contract of indemnity.

(ii) Fire insurance covers the risk of loss by fire where the cause of fire is immaterial for making a claim from the insurance company.

(iii) A ship may be insured against loss by perils of sea.

(iv) For an endowment policy, the insured has to continue paying premium for the whole life.

(v) In life insurance, premium may be paid in a lump sum or in annual instal ments.

(vi) In marine insurance, time policy is often used for hul insurance.

(vii) Fidelity insurance is not compulsory for owners of business.

(viii)The principle underlying the contract of indemnity is to ensure that the insured cannot make profit out of insurance.

5. Fil in the blanks using appropriate word(s):

i. The principle of utmost good faith is based on ____________ between insurers and insured.

ii. In life insurance contract the insurer must have insurable interest at the time of ___________.

iii. The purpose behind the principle of ___________ is that, the insured does not allow making profit from the insurance contract.

iv. If there are two or more insurers and the insurance claim is paid by one of them, other insurers have to contribute ____________ to the insurer who has paid the claim.

6 Enumerate two physical causes of business risks.

7. List two examples of human causes of loss in business.

8. Mention any three characteristics of business risks.

9. Briefly describe physical causes of business risk.

10. Explain the role of profit in business.

11. Explain the natural causes of business risks.

12. What is meant by ‘business risk’?

13. Define Insurance.

14. Why is insurance considered important? List any two reasons.

15. What does ‘Endowment’ life policy mean?

16. What is a ‘Voyage Policy’?

17. What is meant by ‘Hul ’ insurance?

18. Explain how insurance is important as an aid to trade and industry.

19. How does whole life policy differ from endowment life policy? Why life insurance is also called life assurance?

20. Explain the types of risks which are covered by (i) Motor Vehicles insurance; (ii) Fidelity insurance.

21. What purpose does Marine Insurance Policy serve? Explain the different types of marine policies, which may be of use to exporters and importers.

22. A person suf ering from cancer did not disclose this fact while taking a life insurance policy.

Name the principle he violated and explain it about 50 words.

23. At what time there be insurable interest in, a) Life insurance; b) fire insurance; and

c) Marine insurance.

Answer Key to Questions

1. i. True, ii. False, iii. False, iv. True, v. True, vi. True

2. i. Loss, ii. Secured, iii. Securities, iv. Industry

3. i. False, ii. True, iii. True, iv. False, v. True, vi. True, vii. True, viii. True

4. i. Mutual trust and confidence, ii. Contract, iii. Indemnity, iv. Proportionately

Unit-I I

Reconstitution of Partnership- Change in Profit-Sharing Ratio and Admission of a Partner

Abstract

When firm requires additional capital or managerial help or both for the expansion of its business a new partner may be adm it ed to supplement its existing resources. According to the Partnership Act, A new partner can be admit ed into the firm only with the consent of all the existing partners unless otherwise agreed upon. With the admission of a new partner, the partnership firm is reconstituted and a new agreement is entered into to carry on the business of the firm. Sometimes the partners of a firm may decide to change their existing profit sharing ratio.

This may happen an account of a change in the existing partners' role in the firm. For example, Ram, Mohan and Sohan are partners in a firm sharing profits in the ratio of 3:2:1. With ef ect from April 1, 2015 they decided to share profits equal y as Sohan brings in additional capital. This results in a change in the existing agreement leading to reconstitution of the firm. Retirement of a partners means withdrawal by a partner from the business of the firm which may be due to his bad health, old age or change in business interests. In fact a partner can retire any time if the partnership is at wil .

Key terms

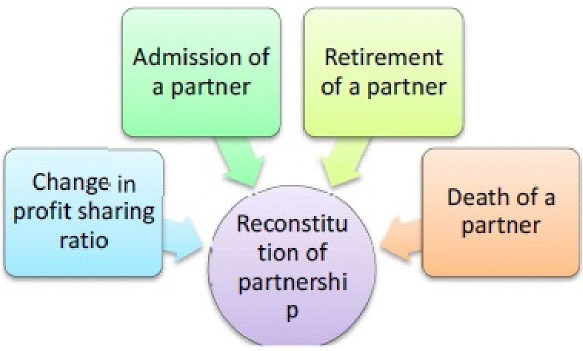
- Reconstitution of partnership
- Change in profit-sharing ration among existing partners
- Admission of a partner
- Retirement of a partner
- Death of a partner

Learning outcomes

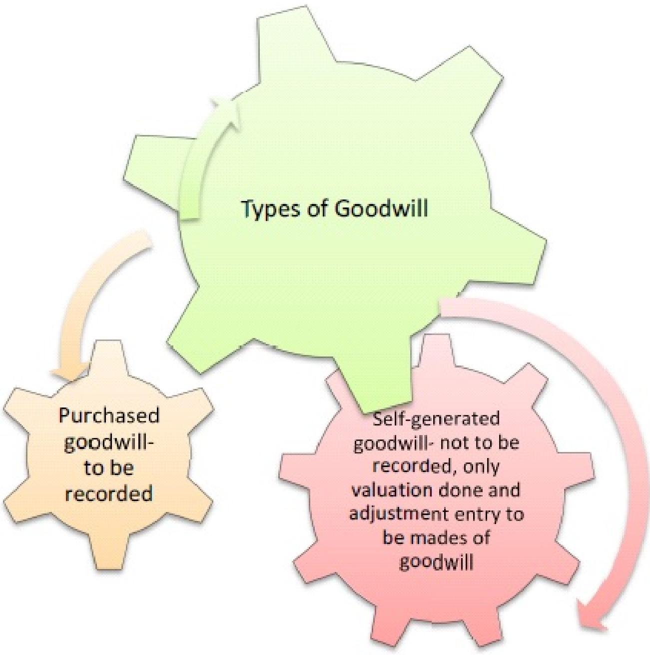
After studying this module, the learners wil able to:

- Identify the mat ers that need adjustments in the books of firm when a new partner is admit ed or a Change in profit-sharing ratio take place;
- Determine the new profit sharing ratio and calculate the sacrificing ratio;
- Describe how goodwil wil be treated under different situations when a new partner is admit ed and a Change in profit-sharing ratio take place;
- Make necessary adjustments for revaluation of assets and reassessment of liabilities;
- Make necessary adjustments for accumulated profits and losses;
- Determine the capital of each partner, if required according to the new profit sharing ratio and make necessary adjustments;

Figure: Reconsitituion of Partnership



Introduction



Need for valuing goodwil : Whenever the mutual rights of the partners changes then party which makes a sacrifice must be compensated. This basis of compensation is goodwil so we need to calculate goodwil .

Mutual rights change under following circumstances:

1) When profit sharing ratio changes

2) On admission of a partner

3) On Retirement or death of a partner

4) When amalgamation of two firms taken place.

5) When partnership firm is sold.

Methods of valuation of goodwil :

1. Average profit method

2. Super profit method

3. Capitalization method

Average Profit Method

The profit earned by a Firm during previous accounting periods on an average basis is called average profit. Goodwil is calculated on the basis of average profit due to future expectations of earning capacity of the firm.

Formula:

Average Profit = Total Profits/No. of Years

Goodwil = Average Profit x Number of years of purchase.

Super Profit Method

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwil is calculated on the basis of Super profit due to future expectations of learning capacity of the firm.

Formula:

Super profit = Average profit - Normal profit

Normal Profit = Investment (Capital Employed) x Normal Rate of Return/100

Goodwil = Super profit x number of years purchased

Capitalisation Method

In this method capitalized value of the firm is calculated on the basis of normal rate of return. difference between the capitalized value and actual capital employed is called goodwil .

Illustration:1

The average net profits expected of a firm in future are 68,000 per year and capital invested in the business by the firm is 3,50,000. The rate of interest expected from capital invested in this class of business is 12%. The remuneration of the partners is estimated to be 8,000 for the year.

You are required to find out the value of goodwil

(a) on the basis of two years' purchase of super profits.

(b) Capitalisation of super profit.

Solution

(a) Average Profit = Average Net Profit - Partner's remuneration

(1)Average profit = 68,000- 8,000 = 60,000

(ii) Normal profit= Capital employed x Normal rate of return/100

= 3,50,000x12/100= 42,000

(iii) Super Profit =Average profit - Normal profit

= 60,000- 42,000 = 18,000

(iv) Value of goodwil = Super profit x No. of years ' purchase

= 18,000x2 = 36,000

(b) Value of Goodwil = Super profit x 100/ Rate of return

=18,000x100/12= 1,50,000

Change in profit sharing ratio among the existing partners

When all the partners of a firm agree to change their profit sharing ratio, the ratio may be changed. In this case one profit is purchasing a share of partner from another one. In other words, share of one partner may increase and share of another partner may decrease.

Accounting treatment of goodwil :

In case of change in profit sharing ratio, the gaining partner must compensate the sacrificing partner by paying the proportionate amount of goodwil .

Illustration 2

Amit and Kajal were partners in a firm sharing profits in the ratio of 3:2. With ef ect from January 1,2012 they agreed to share profits equal y. For this purpose the goodwil of the firm was valued at ‘60,000. Pass the necessary journal entry.

Solution:

Old ratio of A and B = 3:2 New ratio of A and B = 1:1

Sacrifice or Gain:

Amit = 3/5 – 1/2 = 6-5/10 = 1/10 Sacrifice

Kajal = 2/5 – 1/2 = 4-5/10 = 1/10 Gain

Journal

Date	Particulars		L.F.	Debit Rs.	Credit Rs.
2012	Kajal capital A/c	Dr.		6,000	
Jan 1	To Amit' Capital A/c				6,000
	(Adjustment for goodwill on change in profit sharing ratio)				

Accounting treatment of Reserves and Accumulated Profits:

Case (i) When reserves and accumulated profits/losses are to be distributed

At the time of change in profit sharing ratio, if there are some reserves or accumulated profits/losses existing in the books of the firm, these should be distributed to partners in their old profit sharing ratio.

Case (ii) When accumulated profits/losses are not be distributed at the time of change in ratio

Partners may decide that reserves and accumulated profits/losses wil not be affected and remains in the books with same figure. In this case, the gaining partner must compensate the sacrificing partner by the share gained by him i.e.

Gaining Partner's Capital A/c Dr.

To Sacrificing Partner's Capital A/c

Accounting treatment for Revaluation of Assets and reassessment of Liabilities on change in Profit sharing ratio:

At the time of change in profit sharing ratio of existing partners, Assets and liabilities of a firm must be revalued because actual realizable value of assets and liabilities may be different from their book values. Change in the assets and liabilities belongs to the period prior to change in 52 PGT Commerce In-service Training Module - 2 2016 - 17 profit sharing ratio and therefore it must be shared in old profit sharing ratio.

Revaluation of assets and liabilities may be treated in two ways:

(i) When revised values are to be shown in the books.

(ii) When revised values are not to be shown in the books

When revised values are to be shown in the books:

In this case revaluation of assets and liabilities is completed with the help of "Revaluation Account". This account is also known as "Profit and Loss Adjustment Account". All losses due to revaluation are shown in debit side of this account and all gains due to revaluation are shown in credit side of this account.

Note : (1) Increase in the value of an Asset and decrease in the value of a liability result in profit.

(2) Decrease in the value of any asset and Increase in the value of liability gives loss.

Illustration 3:

Piyush, Puja and Praveen are partners sharing profits and losses in the ratio of 3:3:2. There balance sheet as on March 31st 2016 was as follows.

Liabilities		₹	Assets	₹
Sundry creditors		48,000	Cash at bank	74,000
Bank Loan		72,000	Sundry debtors	88,000
Capital:			Stock	2,40,000
Piyush	4,00,000		Machinery	3,18,000
Puja	3,00,000		Building	4,00,000
Praveen	3,00,000	10,00,000		
		11,20,000		11,20,000

Partners decided that with ef ect from April 1, 2016, they would share profits and losses in the ratio of 4:3:2. It was agreed that:

(i) Stock be valued at 2,20,000.

(ii) Machinery is to be depreciated at 10%.

(iii) A provision for doubtful debts is to be made on debtors at 5%.

(iv) Building is to be appreciated by 20%.

(v) A liability for 5,000 included in sundry creditors is not likely to arise.

Partners agreed that the revised value are to be recorded in the books. You are required to prepare journal, revaluation account, partners capital account and revised balance sheet.

Solution:

Journal

Date	Particulars	L.F.	Debit ₹	Credit ₹
2011	RevaluationA/c Dr.		56,200	
	To Stock			20,000
	To Machinery			31,800
	To Provision for doubtful debts A/c			
	(Revaluation of assets)			
	BuildingA/c		80,000	
	Sundry creditors		5,000	
	To Revaluation A/c			85,000
	(Revaluation of assets and liabilities)			
	RevaluationA/c		28,800	
	To Piyush's capital A/c			10,800
	To Pooja's capital A/c			10,800
	To Praveen's capital A/c			7,200
	(Profit on revaluation)			

Dr. **Revaluation Account** Cr.

Particulars		₹	Particulars	₹
To stock		20,000	By building	80,000
To machinery		31,800	By sundry creditors	5,000
To Provision for doubtful debts		4,400		
To profit distributed :				
Piyush	10,800			
Pooja	10,800			
Praveen	7,200			
		28,800		
		85,000		85,000

Partners' Capital Account

Particulars	Piyush	Pooja	Praveen	Particulars	Piyush	Pooja	Praveen
To balance c/d	4,10,800	3,10,800	3,07,200	Bybalance b/d By reval -uation	4,00,000	3,00,000	3,00,000
					10,800	10,800	7,200
	4,10,800	3,10,800	3,07,200		4,10,800	3,10,800	3,07,200

Balance Sheet

as on April 1, 2016

Liabilities		₹	Assets		₹
Sundry creditors		43,000	Cash at bank		74,000
Bank Loan		72,000	Sundry debtors	88,000	
Capital account :			Less : provision 5%	4,400	83,600
Piyush	4,10,000				
Puja	3,10,800		Stock		2,20,000
Praveen	3,07,200		Machinery		2,86,200
		10,28,800	Building		4,80,000
		11,43,800			11,43,800

When revised values are not to be shown in the books

Illustration 4.

In Illustration 3, Partners agreed that the revised value of assets and liabilities are not to be shown in the books. You are required to record the ef ect by passing a single journal entry. Also prepare the revised value balance sheet.

Gain due to revaluation

Building	80,000
Sundry creditors	5,000
Total A	**85,000**

Less: loss due to revaluation

Stock	20,000

Machinery	31,800
Provision for doubtful debts	4,400
Total B	**56,200**
Net gain from revaluation	
Total (A-B)	28,800

OldRatio= 3:3:2

New Ratio = 4:3:2

Sacrifice or Gain :

Piyush = 3/8-4/9 = -5/72 (Gain)

Pooja = 3/8-3/9 = 3/72 (Sacrifice)

Praveen = 2/8-29 = 2/72 (Sacrifice)

Amount to be adjusted :

Piyush = 28,800 x 5/72 = 2,000

Debit

Pooja = 28,800 x 3/72 = 1,200

Credit

Praveen = 28,800 x 2/72 = 800 Credit

Journal

Date	Particulars	L.F. Rs.	Debit Rs.	Credit
2011 Apr. 1	Piyush's capital A/c Dr.		2,000	
	To Pooja's capital A/c			1,200
	To Praveen's capital A/c			800
	(Adjustment for profit on revaluation)			

Capital Accounts

Particulars	Piyush	Pooja	Praveen	Particulars	Piyush	Pooja	Praveen
To Pooja's CapitalA/c	1,200	-	-	By Balance b/d	4,00,000	3,00,000	3,00,000
To Praveen CapitalA/c	800	-	-	By Piyush's CapitalA/c	-	1,200	800
To Balance C/d	3,98,000	3,01,200	3,00,800				
	4,00,000	3,01,200	3,00,800		4,00,000	3,01,200	3,00,800

Balance Sheet

as on April 1, 2011

Liabilities		₹	Assets	₹
Sundry Creditors		48,000	Cash at bank	74,000
Bank Loan		72,000	Sundry debtors	88,000
Capital account :			Stock	2,40,000
Piyush	3,98,000		Machinery	3,18,000
Puja	3,01,200		Building	4,00,000
Praveen	3,00,800			
		10,00,000		
		11,20,000		11,20,000

Admission of a Partner

A newly admit ed partner acquires two main rights in the firm–

1. Right to share the assets of the partnership firm; and

2. Right to share the profits of the partnership firm.

For the right to acquire share in the assets and profits of the partnership firm, the partner brings an agreed amount of capital either in cash or in kind. Moreover, in the case of an established firm which may be earning more profits than the normal rate of return on its capital the new partner is required to contribute some additional amount known as premium or goodwil . This is done primarily to compensate the existing partners for loss of their share in super profits of the firm.

following are the other important points which require attention at the timeof admission of a new partner:

1. New profit sharing ratio;

2. Sacrificing ratio;

3. Valuation and adjustment of goodwil ;

4. Revaluation of assets and Reassessment of liabilities;

5. Distribution of accumulated profits (reserves); and

6. Adjustment of partners' capitals.

Calculation of New Profit-Sharing Ratio: New or incoming partner may acquire his share

from old partner through any of the following methods:

1. In their old profit-sharing ratio

2. In a particular ratio or surrender ratio

3. In a particular fraction from some of the partners.

Calculation of new profit sharing ratio with some illustrations:

Illustration 5

Rajesh and Vishal are partners sharing profits in the ratio of 3:2. They admit ed Sumoy as new partner for 1/5 share in the future profits of the firm. Calculate new profit sharing ratio of Rajesh, Vishal and Sumoy.

Solution:

Sumoy's share in profits= 1/5

Remaining share =1-1/5= 4/5

The remaining sharing wil be divided among old partner in their future profit sharing ratio. It is assumed that the future ratio is old profit sharing ratio of old partners.

Rajesh’s new share in profits= 3/5 of 4/5 =12/25

Vishal’s new share in profits= 2/5 of 4/5 = 8/25

Sumoy’ share in profits= 1/5 or 5/25

New profit sharing ratio of Rajesh, Vishal and Sumoy wil be= 12:8:5

It has been assumed that the new partner acquired his share from old partners in old ratio.

Illustration 6

Anshul and Bharti are partners sharing profits in the ratio of 3:2. They admit ed Seema as new partners for 1/5 share in the future profits of the firm which she gets equal y from Anshul and Bharti. Calculate new profit sharing ratio of Anshul, Bharti and Seema.

Solution

Seema’s Share = 1/5 which is equal y sacrifice by old partner i.e. 1/5*1/2=1/10

Anshul’s new share= 3/5-1/10=5/10

Bharti’s new share=2/5-1/10=3/10

Seema’ share=1/5 or 2/10

New profit sharing ratio of Anshul, Bharti and Seema wil be=5:3:2

Illustration 7

Anshu and Neetu are partners sharing profits in the ratio of 3:2. They admitted Jyotsna as new partners for 30% share in the future profits of the firm which she acquired 2/10 from Anshu and 1/10 from Neetu. Calculate new profit sharing ratio of Anshu, Neetu and Jyotsna.

Solution

Jyotsna’s Share =30% or 3/10

New share= old share- share sacrificed/surrendered

Anshu’s new share=3/5-2/10=4/10

Neetu’s new share=2/5-1/10=3/10

New profit sharing ratio of Anshu, Neetu and Jyotsna wil be=4:3:3

Sacrificing Ratio/ Share= Old Share of Profit- New Share of Profit

Treatment of Goodwil

When premium for goodwil brought in cash by the incoming partner:

.Date	Particulars	L.F.	Dr. (₹)	Cr.(₹)
(i)	Cash/Bank A/c Dr. To Premium for Goodwill A/c (amount brought by the new partner as premium)			
(ii)	Premium for Goodwill A/c Dr. To Sacrificing partners' Capital/Current A/c (premium distributed among sacrificing partners in their sacrificing ratio)			
(iii)	Sacrificing partners' Capital/Current A/c Dr. To Cash/Bank A/c (amount of premium is fully/partly withdrawn by the sacrificing partners)			

Illustration 8

Anshu and Neetu are partners sharing profits in the ratio of 3:2. They admitted Jyostna as new partners for 30% share in the future profits of the firm which she acquired 2/10 from Anshu and 1/10 from Neetu. Jyotsna Bring in 30,000 for capital and requisite amount for premium goodwil in cash, half of premium amount is withdrawn by Anshu and Neetu. The goodwil of the firm valued at 50,000.

Pass the necessary Journal entries in the books of the firm for the above transactions.

Solution: Jyotsna wil bring 15,000 (30% of 50,000) as her share of premium for goodwil . Sacrificing ratio of Anshu and Neetu is 2/10:1/10 or 2:1 (as given)

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr.(₹)
(i)	Cash/Bank A/c Dr.		45,000	
	To Jyostna's Capital A/c			30,000
	To Premium for Goodwill A/c			15,000
	(amount brought by the new partner as premium and capital)			
(ii)	Premium for Goodwill A/c Dr.		15,000	
	To Anshu's Capital A/c			10,000
	To Neetu's Capital A/c			5,000
	(premium distributed among sacrificing partners in their sacrificing ratio)			
(iii)	Anshu's Capital A/c Dr.		5,000	
	Neetu's Capital A/c Dr.		2,500	
	To Cash/Bank A/c			7,500
	(half amount of premium is withdrawn by the sacrificing partners)			

Gain made by an old partner:

Illustration: 9. . (Sacrifice/Gain made by a partner)

Ashok and Ravi were partners in a firm sharing profits and losses in the ratio of 7:3. They admit ed Chander as a new partner. The new profit ratio between Ashok, Ravi and Chander wil be 2:2:1. Chander brought 24,000 for his share of his goodwil . Pass necessary journal entries for the treatment of goodwil .

Solution:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr.(₹)
(i)	Cash/Bank A/c	Dr.		24,000	
	To Premium for Goodwill A/c				24,000
	(amount brought by the new partner as premium)				
(ii)	Premium for Goodwill A/c	Dr.		24,000	
	Ravi's Capital A/c	Dr.		12,000	
	To Ashok's Capital A/c				36,000
	(Amount of goodwill distributed among sacrificing partners in their sacrificing ratio,)				

Note : Calculation of sacrifice/gain share of partners(s) :

Sacrificing ration = Old ratio- New ratio Ashok = 7/10 – 2/5 = 7-4/10 = 3/10 sacrifice Ravi = 3/10 – 2/5 = 3-4/10 = (-1/10) gain

Being negative result, it shows gain. Since Ravi is gaining equal to 1/10 in the profits, therefore, he wil also compensate Ashok proportionately. For 1/5 share Chander brought 24,000, therefore, Ravi wil compensate Ashok by 12,000 i.e., 24,000 x 5/1 x 1/10.

When the new partner is unable to bring his share of goodwill in cash

Sometimes the new partner does not bring his share of goodwil in cash. Then his share of goodwil is calculated and adjusted by the following Journal entry.

New Partners' Capital /Current A/c Dr.

To Sacrificing partners' Capital/ Current A/cs

(in the sacrificing ratio).

Illustration: 10.

Neeta and Sumita are partners sharing profits and losses in the sates 2:1. They admit Geeta as a partner for 1/4th Share. Geeta pays 50,000 as capital but does not bring any amount for goodwil . The goodwil of the new firm is valued at 36,000. Journalise the above transactions.

Solution:

Journal

Date	Particulars		L.F.	Dr. (₹)	Cr.(₹)
(i)	Cash/Bank A/c	Dr.		50,000	
	To Geeta's Capital A/c				50,000
	(amount brought by the new partner as capital)				
(ii)	Geeta's Capital A/c	Dr.		9,000	
	To Neeta's Capital A/c				6,000
	To Sumita's Capital A/c				3,000
	(Amount of goodwill distributed among sacrificing partners in their sacrificing ratio,)				

Working Note :

(1) As nothing is given about sacrifice etc. except the old ratio and the new partners share of profit

Sacrificing Ratio=Old Ratio=2:1

(2) Goodwil of the firm=Rs.36,000

(3) Geeta's share of profit = 1/4

Geeta's share of Goodwil =Rs.36,000x1/4=Rs.9,000

Illustration: 11. (Hidden Goodwil)

A and B are partners with capitals of 26,000 and 22,000 respectively. They admit C as partner with 1/4th share in the profits of the firm. C brings 26,000 as his share of capital. Give journal entry to record goodwil on C's admission.

(CBSE 2001 Compt.)

Solution:

Journal

Date	Particulars	L.F.	Dr. (₹)	Cr.(₹)
(i)	Cash/Bank A/c Dr. To C's Capital A/c (amount brought by the new partner as premium)		26,000	 26,000
(ii)	C's Capital A/c Dr. To A's Capital A/c To B's Capital A/c (premium distributed among sacrificing partners in their sacrificing ratio)		7,500	 3,750 3,750

Notes :(1) Calculation of C's share of goodwil :

Total capital of new firm on basis of C's capital i.e., 26,000 x 4/1	1,04,000
Total capital of A and B and C i.e., 26,000+ 22,000 + 26,000	(74,000)
Goodwil of the firm	30,000
Thus C's share of goodwil = 30,000 x1/4=	7,500

(2) In the absence of information, profits wil be shared equal y.

4. Accounting treatment for revaluation of assets and re-assessment of liabilities:

The assets and liabilities are generally revalued at the time of admission of a new partner. Revaluation Account is prepared for this purpose in the same way as in case of change in profit sharing ratio. This account is debited with all losses and credited with all gains. Balance of Revaluation Account is transferred to old partners in their old ratio.

Illustration: 12. A, B and C are partners sharing profits and losses in the ratio of 2:3:5. On 31st March 2016, their Balance Sheet was as follows:

Liabilities		₹	Assets	₹
A	36,000		Cash	18,000
B	44,000		Bills receivable	24,000
C	52,000	1,32,000	Furniture	28,000
Creditors		64,000	Stock	44,000
Bill Payable		32,000	Debtors	42,000
Profit and Loss Account		14,000	Investments	32,000
			Machinery	34,000
			Goodwill	20,000
		2,42,000		2,42,000

They admit D into partnership on the following terms:

(i) Furniture and Machinery to be depreciated by15%.

(ii) Stock is revaluated at 48,000.

(iii) Goodwil To be valued at 24,000.

(iv) Outstanding rent amount to 1,800.

(v) Prepaid salaries 800.

(vi) D to bring 32,000. Towards his capital for 1/6th share.

Prepare Revaluation Account, Partners Capital Accounts and Balance Sheet of the new firm. **(CBSE 2001)**

Solution:

Revaluation Account

Dr. Cr.

Particulars	₹	Particulars	₹
To furniture A/c To Machinery A/c To Outstanding rent A/c	4,200 5,100 1,800	By Stock A/c By Prepaid salaries A/c By Capital A/c (loss) : A 2/10 -1,260 B 3/10 -1,890 C 5/10 -3,150	4,000 800 6300
	11,100		11,100

Partners' Capital Accounts

Dr. Cr.

Particulars	A	B	C	D	Particulars	A	B	C	D
To Revaluation A/c	1,260	1,890	3,150	–	By balance c/d	36,000	44,000	52000	
To Goodwill A/c	4,000	6,000	10,000	–	By P/L A/c	2,800	4,200	7,000	
To A's capital	–	–	–	8,00	By D's	–	–		–
To B's capital	–	–	–	1,000	capital	8,000	1,200	2,000	
To C's capital	–	–	–	2,000					
To Balance C/d	34,340	41,510	47,850	28,000	ByCash A/c				32000
	39600	49400	61000	32,000		39600	49400	61000	32000

Balance Sheet of New Firm

Liabilities		₹	Assets	₹
Capital:			Cash	50,000
A	34,340		Bills Receivable	24,000
B	41,510		Furniture	23,800
C	47,850		Stock	48,000
D	28,000	1,51,700	Debtors	42,000
Creditors		64,000	Investment	32,000
Bills Payable		32,000	Machinery	28,900
Outstanding rent		1,800	Prepaid Salaries	800
		2,49,500		2,49,500

Adjustment of capital in new profit sharing ratio

Illustration:13. A, B and C are partners sharing profits and losses in the ratio of 5:3:2.

On March 31, 2016 their Balance Sheet was as follows:

Liabilities		₹	Assets	₹
Capital:			Cash	18,000
A	36,000		Bill Receivable	14,000
B	44,000		Stock	44,000
C	52,000	1,32,000	Debtors	42,000
Creditors		64,000	Machinery	94,000
Bills Payable		32,000	Goodwill	20,000
General Reserve		14,000		
		2,32,000		2,32,000

They decided to admit D into the partnership on the following terms:

(i) Machinery is to be depreciated by 15 %.

(ii) Stock is to be revalued at 48,000.

(iii) A, Band C have a unrecorded investments which valued at 12,000.

(iv) Outstanding rent is 1,900.

(v) D is to bring 6,000 as goodwil and suf icient capital for a 2/5th share in the

capitals of firm.

Prepare Revaluation A/c, Partner’s Capital A/c, Cash A/c and Balance Sheet of the new firm.

Solution:

Dr. Revaluation Account Cr.

Particulars	Rs.	Particulars	Rs.
To Machinery A/c To outstanding Rent	14,100 !,900	By Stock A/c By Investment A/c	4,000 !2,000
	16,000		16,000

Partners' Capital Accounts

Particulars	A (₹)	B (₹)	C (₹)	D (₹)	Particulars	A (₹)	B (₹)	C (₹)	D (₹)
To Goodwill A/c	10,000	6,000	4,000	–	By Balance b/d	36,000	44,000	52,000	–
				–	By General reserve	7,000	4,200	2,800	–
To Balance c/d	36,000	44,000	52,000	–					–
					By Premium for goodwill	3,000	1,800	1,200	–
					By cash A/c				88000
	52,000	53,600	58,400	88,000		36,000	44,000	52,000	88000

Note : Combined capital of A, B and C for 3/5 (1-2/5) = 1,32,000

Thus total capital of the firm = 1,32,000x5/3 = 2,20,000

D's share of capital = 2,20,000x2/5 = 88,000

Balance Sheet of the New Firm

Liabilities			₹	Assets	₹
Creditors			64,000	Cash	1,12,000
BillPayable			22,000	Bills receivable	14,000
Outstanding rent			1,900	Stock	48,000
Capital				Debtors	42,000
	A	36,000		Machinery	79,000
	B	44,000		Investments	12,000
	C	52,000			
	D	88,000	2,20,000		
			3,07,900		3,07,900

1. Matters requiring adjustments at the time of admission of a partner: Various mat ers which need adjustments in the books of sum firm at the time of admission of a new partner are : goodwil , up revaluation of assets and liabilities, reserves and other accumulated profits and losses and the capitals of the old partners (if agreed).

2. Determining the new profit sharing ratio and calculating sacrificing ratio: The new partner acquires his share in profits from the old partners. This reduces the old partner’s share in profits. Hence, the problem of determining the new profit sharing ratio simply involves the determination of old partner’s new share in the profits of the reconstituted firm. Given the new partner’s share in profits and the ratio, in which he acquires it from the old partners, the new share of each old partner shal be worked out by deducting his share of sacrifice from his old share in profits. The ratio in which the old partners have agreed to sacrifice their shares in profit in favour of the new partner is called the sacrificing ratio. It is usual y same as the old profit sharing ratio. However, based on the agreement it can be different also.

3. Treatment of Goodwil : Goodwil is an intangible asset and belongs to its owner at a point of time. On the admission of a new partner the goodwil of the firm belongs to the old partners. It means that on the admission of a new partner some adjustments must be made into the capital accounts of the old partners for 68 PGT Commerce In-service Training Module - 2 2016 - 17 goodwil so that the new partner wil not acquire a share in that profit which the firm earns because of its goodwil earned before admission without making any payment for the same. The amount that the new partner pays for goodwil is called goodwil . From accounting point of view the firm may have to face different situations for the treatment of goodwil at the time of admission of a partner. The amount of premium brought in by the new partner is shared by old partners in the ratio of sacrifice. In case the new partner fails to bring his share of premium for goodwil in cash than the capital account of the new partner is debited for his share of premium of goodwil and the old partners’ capital accounts are credited in their sacrificing ratio.

4. Adjustments for Revaluation of Assets and Reassessment of Liabilities: If, at the time of admission of a partner, the assets and liabilities are revalued or some asset or liability is found unrecorded, necessary adjustments are made through the Revaluation Account. Any gain or loss arising from such exercise shal be distributed among the old partner's in their old profit sharing ratio.

5. Adjustment for reserves and accumulated profits/losses: If, at the time of admission of a partner, any reserve and accumulated profits or losses exist in books of the firm, these should be transferred to old partner's capital/current accounts in their old profit sharing ratio.

6. Determining/Adjusting partners' capital: If agreed, the partner's capital may be adjusted so as to be proportionate to their new profit sharing ratio. In that case, the new partner's capital is normal y used as a base for determining the new capitals of the old partners and necessary adjustment made through case or by transfer to partner's current accounts. Other basis also may be available for determining capitals of the partners after admission of the new partner like sharing the total capital to be in the firm immediately after admission of the new partner.

7. Change in profit sharing ratio: Sometimes the partners of a firm may agree to change their existing profit sharing ratio. With a result, some partners wil gain in future profits while others wil lose. In such a situation, the partner who gains by change in profit ef ecting amounts to one partner buying the share of profit from another partner. Apart from the payment for compensation, the change in profit sharing ratio also necessitates adjustment in partner's capital accounts with respect to undistributed profits and reserves, revaluation of assets and reassessment of liabilities.

Frequently Asked Questions (FAQ's)

1. A and B were partners in a firm. They admit ed C as a new partner for 20% share in the profits. After all adjustments regarding general reserve, goodwil , gain or loss on revaluation, the balances in capital accounts of A and B were 3,85,000 and 4,15,000 respectively. C brought proportionate capital so as to give him 20% share in the profits. Calculate the amount of capital to be brought by C.

2. A, B and C are the partners sharing profits and losses in the ratio of 5:3:2. C retired and his capital balance after adjustments regarding Reserves, Accumulated profits/ losses and gain/loss on revaluation was 2,50,000. C was paid 3,00,000 in ful set lement. Afterwards D was admit ed for 1/4th share. Calculate the amount of goodwil premium brought by D.

3. Rekha, Sunita and Teena are partners in a firm sharing profits in the ratio of 3:2:1. Samiksha joins the firm. Rekha surrenders 1/4th of her share; Sunita surrenders 1/3rd of her share and Teena 1/5th of her share in favour of Samiksha. Find the new Profit sharing ratio.

4. X, Y and Z were partners sharing profits equal y. On 1.1.2012 they decided to share their future profits in the ratio of 1:2:2, on the same date the firm has a balance of Rs. 60,000 as general reserve and Rs. 18,000 in the P&L A/c (Dr.) Journalise.

5. H and I were partners in a firm. They started a factory in a hil y area from where they get raw material at a lower cost. They admit a blind person G as a new partner on 1.4.2015 for 1/3 share. It was decided that G would bring Rs. 50,000 in cash for his share of goodwil and machinery worth Rs. 70,000 for his capital. H and I were sharing profits in the ratio 3:1 but now they decided to share profits equal y in future.

   a. Identify two values in the above question.

   b. Pass necessary journal entries.

6. What do you understand by reconstitution of partnership firm?

7. Karan, Nakul and Asha were partners in a firm sharing profits and losses in the ratio 3:2:1. At the time of admission of a partner, the goodwil of the firm was valued at 2,00,000. The accountant of the firm passed the entry in the books of accounts and thereafter showed goodwil at 2,00,000 as an asset in the Balance Sheet. Was he correct in doing so? Why?

8. (a) A firm earned profits of 80,000, 1,00,000, 1,20,000 and 1,80,000 during 2010- 11, 2011-12, 2012-13 and 2013-14 respectively. The firm has capital investment of 5,00,000. A fair rate of return on investment is 15% p.a. Calculate goodwil of the firm based on three years' purchase of average super profits of last four years.

(b) Kabir and Farid are partners sharing profits and losses in the ratio of 7:3. Kabir surrenders 2/10th from his share and Farid surrenders 1/10th from his share in favour of Jyoti, a new partner. Calculate new profit sharing ratio and sacrificing ratio.

9. A business has entered average profit of 4, 00,000 during the last few years and the normal rate of return in similar business is 10%. Find out the value of goodwil by

(i) Capitalisation of super profit method, and

(ii) Super profit method if the goodwil is valued at 3 years purchase of super profits.

The Assets of the business were 40, 00,000 and its external Liabilities 7, 20,000.

UNIT-IV

Sources of Business Finance

Abstract

Finance is the life blood of any organization. The existence, survival and growth of the business depend on finance. The requirement of the finance in the form of fixed capital and working capital are dependent on its size and scale of operations. The business can acquire its finance for short-term and long-term through various sources. A careful and effective financial planning wil ensure adequate availability of funds at lowest cost and all ocation & utilization of these funds for maximum benefits. The doctor has to purchase medical equipment and furniture to run his clinic, the shopkeeper has to buy groceries, the tailor has to purchase sewing machine, threads and other stitching materials for his work. Thus, any type of business or occupation requires money at every stages of its operation. Now, the question arises from where do the businessmen gather the required amount of money? Are they able to manage with their own money to start and run their business? Obviously, it is dif icult and in case of large business, it is ruled out. So we have to know about the various options available to them to arrange the required amount of funds (also called capital). In this lesson, we shal try to find out the answer to such questions. Having learnt about the need, importance and types of financial requirements, now we must know from where the businessmen get the required amount of funds to meet the short-term, medium term and long term requirements. Who provides them the required amount? Let us learn about the various sources from which the businessmen generally arrange money for business purposes.

Learning Outcomes

After studying this Unit, Learners wil be able to:

- explain the various sources of Business Finance;
- explain the various methods of raising Short Term Finance;
- explain the types of Securities required for bank credit;
- explain the various methods of raising Long Term Finance;
- differentiate between various sources of finance;
- Understand the concept of fixed and Working Capital
- Describe the factors determining the requirements of fixed and Working capital

Key Terms : Business Finance, Securities, Short Term Finance, Long Term Finance, bank credit, Fixed capital, capital budgeting decision, working capital, business cycle, production cycle, operating efficiency, inflation.

Sources of Business Finance

Broadly speaking, there are two main categories of sources from which the businessmen can get the required funds for their business. These are: (1) internal source; and (2) external source. You know that to start a business the businessman either invests his own money or borrows from outsiders or uses both the sources. When the businessman invests his own money (called owner’s capital), and retains a part of the profits earned in the business it constitute the internal sources of finance. It is an integral part of every business organisation and it is cost effective. But, this source has its own limitations. Hence, the business enterprises have to resort to the external sources of finance. The various external sources from where businessmen can get the finance include, friends and relatives, banks and other financial institutions, moneylenders, capital market, manufacturers and producers, customers, foreign financial institutions and agencies, etc.

It is observed that the scope of raising funds also depends upon the nature and form of business organisation. For example, a sole proprietorship form of business organization has very limited sources from which it can arrange funds for the business. These are:

(a) Own Savings

(b) Friends and Relatives

(c) Moneylenders

(d) Commercial Banks

(e) Finance Companies

(f) Manufactures and Suppliers

(g) Retained Profits

The same sources of financing are also available in case of partnership firms. In both sole proprietorship and partnership form of business organisation, long term capital is generally provided by the owners themselves by way of investing their own savings and retaining a part of the profits generated by the business and the rest of the above sources are mostly used for their short-term financial needs. However, in case of companies, the following are the usual sources of finance:

(a) Capital Market

(b) Financial Institutions

(c) Public Deposits

(d) Commercial Banks

(e) Leasing Companies

(f) Investment Trusts

(g) Retained Profits.

METHODS OF RAISING SHORT-TERM FINANCE

Short term finance is required for a period of upto one year. This type of finance is required for arranging raw materials, payment of wages and salaries and other expenses of the business.

There are many methods used for raising short-term finance. These are:

1. Trade credit

2. Bank credit

– Loans and Advances

– Cash Credit

– Bank Overdraft

– Discounting of Bills

3. Factoring

4. Customers’ Advances

5. Instal ment Credit

6. Loans from Unorganised sectors

Let us know in details about them.

1. Trade Credit

Trade credit refers to credit granted to manufacturers and traders by the suppliers of raw material, finished goods, components, etc. Usual y business enterprises buy goods on 30 to 90 days credit. This means that the goods are delivered but payment is not made until the expiry of the period of credit.

This type of credit does not make the funds available in cash but it facilitates purchases without making immediate payment which amounts to funding it by suppliers. This is a very popular source of short term finance.

2. Bank Credit

Commercial banks usual y provide short-term finance to business firms, which is known as bank credit. When bank credit is granted, the borrower gets a right to draw the amount of credit as and when needed. Bank credit may be granted in any of the following ways:

(a) Loans and Advances: When a certain amount of money is advanced by a bank repayable after a specified period, it is known as bank loan. Such advance is credited to a separate loan account and the borrower has to pay interest on the whole amount of loan irrespective of the amount of loan actual y drawn. Usual y loans are granted against security of assets.

(b) Cash Credit: It is an arrangement whereby banks allow the borrower to withdraw money up to a specified limit. This limit is known as cash credit limit. This facility is granted against the security of goods in stock or promissory notes or other marketable securities like government bonds. Under this arrangement, the borrower can draw, repay and again draw the amount within the sanctioned limit. Interest is charged only on the amount actual y withdrawn and not on the amount of entire limit.

(c) Bank Overdraft: When a bank al ows its depositors or accountholders to withdraw money in excess of the balance in his current deposit account up to a specified limit, it is known as overdraft facility. This limit is granted purely on the basis of credit-worthiness of the borrower. Interest is charged only on the overdrawn money. Rate of interest in case of bank overdraft is less than the rate charged under cash credit.

(d) Discounting of Bil : Banks also give advance money by discounting bil of exchange. When a bil of exchange is presented before the bank for encashment, bank credits the amount to customer's account after deducting some discount. The amount of discount is charged on the basis of the interest for the period of bil . On maturity of the bil , the payment is received by the bank from the drawee.

Distinction between Cash Credit and Bank Overdraft

(i) Cash credit is an arrangement of credit granted by a bank to a firm. The firm may or may not have an account with the bank. Overdraft is granted to an accountholder purely on the basis of his credit-worthiness. Credit worthiness is decided by the financial soundness of past dealings of the customer with the bank.

(ii) In case of cash credit, the amount of credit is placed in a separate account of the borrower. Overdraft limit is generally granted to an existing account of the customer.

(iii) The amount of credit in case of cash credit depends upon the value of securities offered. But overdraft limit is decided on the average balance in the customer's account.

(iv) Overdraft is granted without the security of any assets. But for cash credit, security of tangible assets is an essential requirement.

3. Factoring

Factoring is a method of raising short-term finance for the business in which the businessmen take advance money from the bank against the amount to be realised from the debtors. By this method, the firm shifts the responsibility of col ecting the outstanding amount from the debtors on payment of a specified charge. Here the business gets the money in advance without waiting for due date. Also it saves the effort of col ecting the debts.

4. Customers' Advances

Sometimes businessmen insist their customers to make some advance payment at the time of placing order. It is generally asked when the value of order is quite large or goods ordered are very costly. Customers' advance represents a part of the payment towards sale price of the product(s), which wil be delivered at a later date. Customers generally agree to make advance payment when such goods are not easily available in the market or there is an urgent need of any goods. A firm can meet its short-term requirements with the help of customers' advances.

5. Loans from Unorganised Sector

In addition to the above methods of raising funds, the businessmen always have the option to take the money from the unorganised sector like loans from the moneylender (called indigenous bankers), friends and relatives. To meet the short-term and urgent need of business, money can be obtained from them either on personal security or on security of tangible assets and personal properties. Since the interest charged on loans from unorganised sector is normal y very high, the businessmen are not very keen to avail of loan from this source.

TYPES OF SECURITY REQUIRED FOR OBTAINING BANK CREDIT

We learnt that loans and advances are granted by the banks on the basis of some security, which wil ensure the bank for safe return of its money. This security may be personal security of the borrower as wel as on the security of some assets, besides the standing of the firm. Thus, securities of ered against bank credit may be of two types:

(1) Personal security

(2) Security of assets

Personal security means the credit-worthiness of the borrower. Banks judge the creditworthiness of the borrower on the basis of his financial soundness and past dealings with the bank, and then sanction the amount. When the banks ask for security of assets, the following are generally accepted as security for extending short-term finance.

(a) **Moveable Goods:** Stock of raw materials and finished goods are accepted by banks as security against bank credit. In case of non-payment, these goods are sold and money is recovered by banks.

(b) **Shares:** Shares that are quoted on a recognised stock exchange are accepted as security against bank credit. The borrower is required to assign his shareholding in favour of the bank.

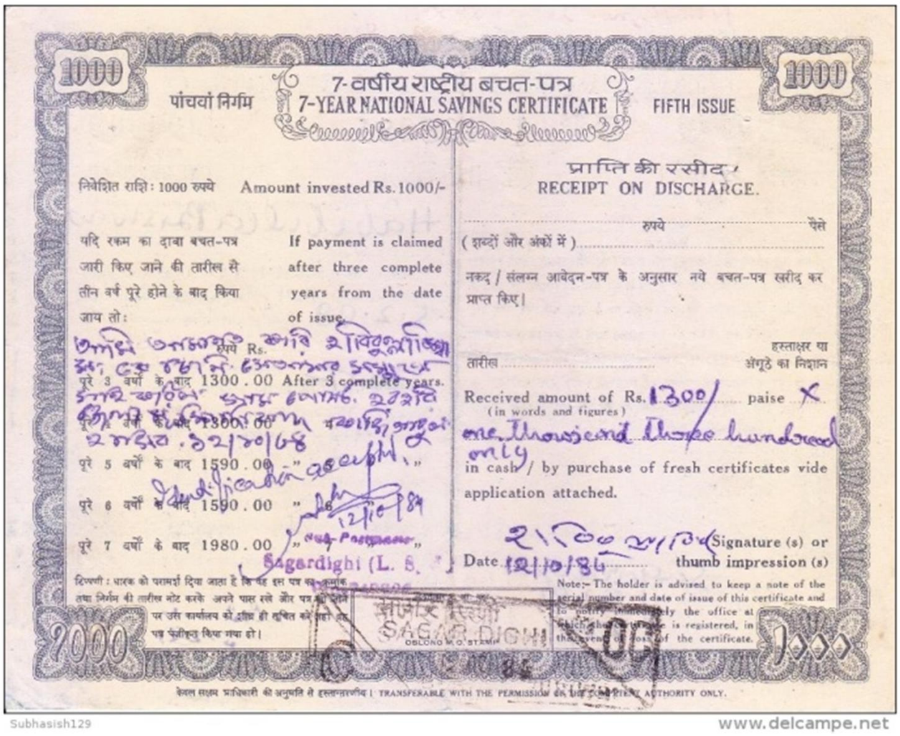
(c) **Documents of Title to Goods:** Bil of Lading, Railway Receipts (RR), Goods Receipt (GR), Warehouse warrant are various documents which are recognised as documents of title to goods. To secure credit from bank, the borrower may deposit any of these documents with bank after duly endorsing the same in favour of the bank. This enables the bank to deal with the goods in case of default in repayment.

(d) **Fixed Deposit Receipts:** It is a receipt issued by bank as evidence of fixed deposit made by the customer. Banks grant loan on the security of this receipt. Banks normal y grant loan upto 90% of the value of such receipts.

(e) **Life Insurance Policies:** Banks extend credit on the basis of life insurance policy upto the amount of surrender value of such receipts.

(f) **Jewellery or Precious Metals:** This type of security may be of ered to borrow money for private as wel as for business purposes. Sole proprietary concerns sometimes of er jewel ery or other precious metals to obtain credit.

(g) **Other Securities:** Besides the assets and documents mentioned above, banks also accept National Savings Certificate (NSC), Kisan Vikas Patra (KVP), and Government Bonds for grant of short-term credit.



1000 पांचवां निर्गम 7-वर्षीय राष्ट्रीय बचत-पत्र 7-YEAR NATIONAL SAVINGS CERTIFICATE FIFTH ISSUE 1000

निवेशित राशि: 1000 रुपये Amount invested Rs. 1000/-

यदि रकम का दावा बचत-पत्र जारी किए जाने की तारीख से तीन वर्ष पूरे होने के बाद किया जाय तो: If payment is claimed after three complete years from the date of issue

पूरे 3 वर्षों के बाद	1300.00	After 3 complete years.
पूरे 5 वर्षों के बाद	1590.00	"
पूरे 6 वर्षों के बाद	1590.00	"
पूरे 7 वर्षों के बाद	1980.00	"

Sagardighi (L. S.)

प्राप्ति की रसीद
RECEIPT ON DISCHARGE.

रुपये पैसे (शब्दों और अंकों में)

नकद / संलग्न आवेदन-पत्र के अनुसार नये बचत-पत्र खरीद कर प्राप्त किए।

तारीख हस्ताक्षर या अंगूठे का निशान

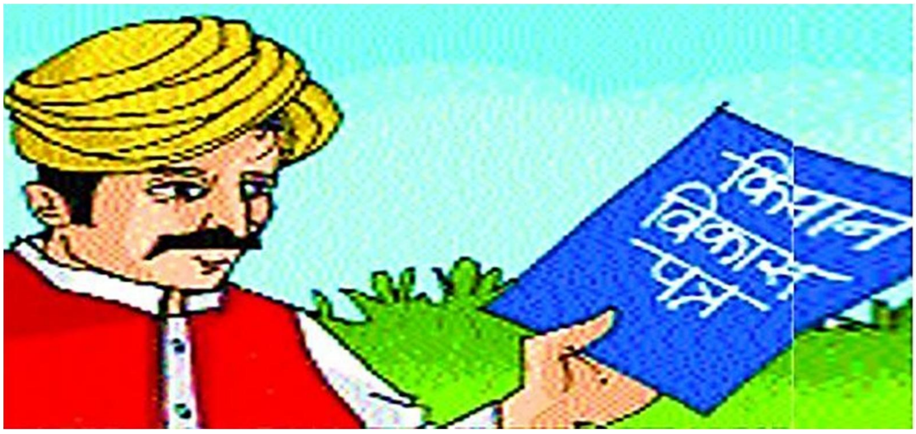
Received amount of Rs. 1300/ paise X (in words and figures) one thousand three hundred only in cash / by purchase of fresh certificates vide application attached.

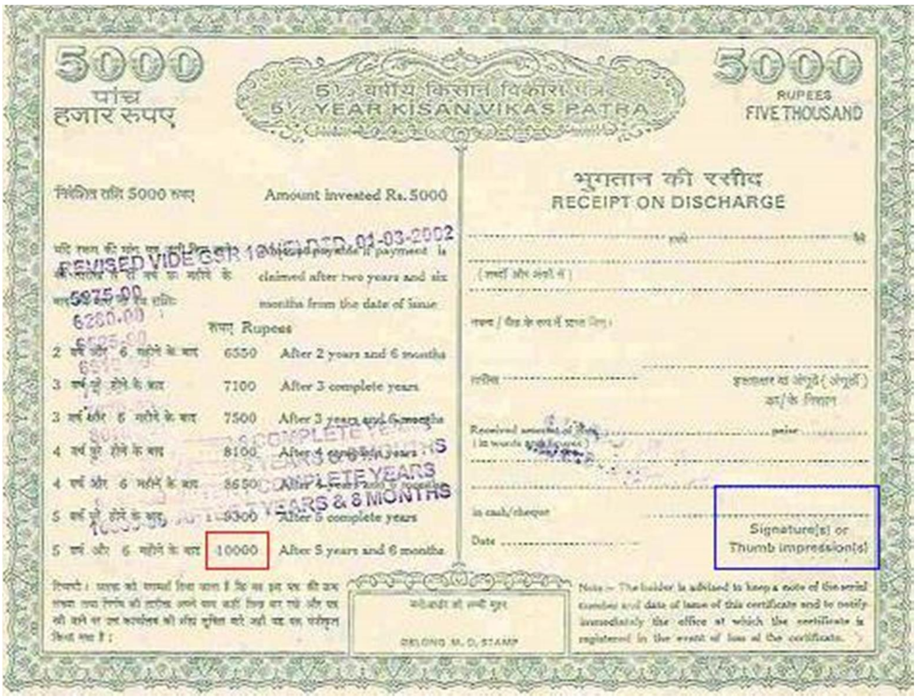
Date 12/10/84 Signature (s) or thumb impression (s)

Note:- The holder is advised to keep a note of the serial number and date of issue of this certificate and to notify immediately the office at which the certificate is registered, in the event of loss of the certificate.

केवल सक्षम प्राधिकारी की अनुमति से हस्तान्तरणीय। TRANSFERABLE WITH THE PERMISSION OF THE COMPETENT AUTHORITY ONLY.

Subhasish129 www.delcampe.net





5000 पांच हजार रुपए 5½ वर्षीय किसान विकास पत्र 5½ YEAR KISAN VIKAS PATRA 5000 RUPEES FIVE THOUSAND

निवेशित राशि 5000 रुपए Amount invested Rs. 5000

REVISED VIDE GSR 1... DATED 01-03-2002

If payment is claimed after two years and six months from the date of issue

रुपए Rupees

2 वर्ष और 6 महीने के बाद	6550	After 2 years and 6 months
3 वर्ष पूरे होने के बाद	7100	After 3 complete years
3 वर्ष और 6 महीने के बाद	7500	After 3 years and 6 months
4 वर्ष पूरे होने के बाद	8100	After 4 complete years
4 वर्ष और 6 महीने के बाद	8650	After 4 years and 6 months
5 वर्ष पूरे होने के बाद	9300	After 5 complete years
5 वर्ष और 6 महीने के बाद	10000	After 5 years and 6 months

भुगतान की रसीद
RECEIPT ON DISCHARGE

Received amount of Rs. ... paise (in words and figures) in cash/cheque

Date

Signature(s) or Thumb impression(s)

OBLONG M.D. STAMP

Note:- The holder is advised to keep a note of the serial number and date of issue of this certificate and to notify immediately the office at which the certificate is registered in the event of loss of the certificate.

After knowing the various methods of raising short-term finance let us now learn about the methods of raising long-term finance.

METHODS OF RAISING LONG TERM FINANCE

Long term finance is required for a period of more than five years. This type of finance is required for acquiring fixed assets like land, building, plant, machinery etc. In smal organisations the long-term finances are generally provided by the owners. But for large organisations like joint stock companies there are various options available to raise the funds. followings are the most commonly used methods of long-term finance:

(i) Issue of Shares

(ii) Issue of Debentures

(iii) Loans from financial institutions

(iv) Public Deposits

(v) Retention of Profit

(vi) Lease financing

(vii) Foreign Investment

Let us now discuss about these in detail.

ISSUE OF SHARES

Share is the smal est unit into which the total capital of the company is divided. For example, when a company decides to raise 50 crores of capital from the public by issuing shares, then it can divide its capital into units of a definite value, say 10 or 100 each. These individual units are called as its share. After deciding the value of each share and number of shares to be issued, the company then invites the public to buy the shares. The investing public then buys the shares as per their capabilities. The investors who have purchased the shares or invested money in the shares are called the shareholders. They get dividend as return on their investment.

We know that investors have different habits and temperaments. Some want to take lesser risk and are interested in a regular income while others are ready to take greater risk in anticipation of huge profits in future. In order to tap the savings of different types of people, a company can issue two types of shares, viz. (a) Equity Shares, and (b) Preference shares.

(a) Equity Shares

Equity shares are shares, which do not enjoy any preferential right in the mat er of claim of dividend or repayment of capital. The equity shareholders get dividend only after making the payment of dividends on preference shares. There is no fixed rate of dividend for equity shareholders. The rate of dividend depends upon the surplus profits. In case there are good profits, the company pays dividend to the equity shareholders at a higher rate. Again in case of winding up of a company, the equity share capital is refunded only after refunding the claims of others. In fact they are regarded as the owners of the company who exercise their authority through the voting rights they enjoy. The money raised by issuing such shares is known as equity share capital. It is also called as ownership capital or owners' fund.

Merits of Equity Shares

From Shareholders point of view	From Management point of view
• The equity shareholders are the owners of the company. • It is suitable for those who want to take risk for higher return. • The value of equity shares goes up in the stock market with the increase in profits of the concern. • Equity shares can be easily sold in the stock market. • The liability of the shareholder is limited to the nominal value of shares held by him. • Equity shareholders have a in the management of a company as they are conferred with voting rights.	• A company can raise capital by issuing equity shares without creating any charge on its fixed assets. • The capital raised by issuing equity shares is not required to be paid back during the lifetime of the company. It will be paid back only when the company is winded up. • There is no binding on the company to pay dividend on equity shares. The company may declare dividend only if there is enough profit. • If a company raises more capital by issuing equity shares, it leads to greater confidence among the creditors.

Limitations of Equity Shares

From Shareholders point of view	From Management point of view
• Equity shareholders get dividend only when the company earns sufficient profits. The decision to declare dividend lies with the Board of Directors of the company. • There is high speculation in equity shares. This is particularly so in the time of boom when profitability of the companies is high. • Equity shareholders bear a very high degree of risk. In case of losses they do not get dividend, and in case of winding up of a company, they are the last to get the refund of their money invested. Equity shares actually swim and sink with the fate of the company.	• It requires more formalities and procedural delay to raise funds by issuing equity shares. Also the cost of raising capital through equity share is more as compared to debt. • As the equity shareholders carry voting rights, groups are formed to garner the votes and grab the control of the company. This may lead to conflict of interests, which is harmful for the smooth functioning of a company.

(b) Preference Shares

Preference Shares are those shares, which carry preferential rights in respect of dividend and return of capital. Before any dividend is paid to the equity shares, the dividend at a fixed rate must be paid on the preference shares. However, this dividend is payable only if there are profits. Again at the time of winding up, the holder of the preference shares wil get the return of their capital before anything is paid to the equity shareholders. The holders of the preference shares do not have any voting right. So, they cannot take part in the management of the company. It is not compulsory on the part of the company to issue preference shares.

Types of Preference Shares

A company has the option to issue different types of preference share. Let us see the different types of preference shares a company can issue.

(i) Convertible and Non-convertible Preference Shares

The preference shares which can be converted into equity shares after a specified period of time are known as convertible preference shares. Otherwise, these are known as non-convertible preference shares.

(ii) Cumulative and Non-cumulative Preference Shares

In cumulative preference shares, the unpaid dividends are accumulated and carried forward for payment in future years. On the other hand, in non-cumulative preference share, the dividend is not accumulated if it is not paid out of the current year's profit.

(iii) Participating and Non-participating Preference Shares

Participating preference shares have a right to share the profit after making payment to the equity shares. The non-participating preference shares do not enjoy such a right.

(iv) Redeemable and Irredeemable Preference Shares

Preference shares having a fixed date of maturity are called as redeemable preference share. Here, the company undertakes to return the amount to the preference shareholders immediately after the expiry of a fixed period. Where the amount of the preference shares is refunded only at the time of liquidation, such shares are known an irredeemable preference shares.

Difference between equity shares and preference shares

We have already learnt the meaning and features of equity and preference shares.

Now let us find out the differences between these two.

Basis of difference	Equity shares	Preference Shares
(i) Choice	It is compulsory to issue these shares.	It is not compulsory to issue these shares.
(ii) Payment of dividend	Dividend is paid on these shares only after paying dividend on preference shares.	Dividend is paid on these shares in preference to the equity shares.
(iii) Return of capital	In case of winding up of the company the equity share capital is refunded only after the refund of preference share capital.	In case of winding up of the company the capital is refunded in preference over the equity shares.
(iv) Voting Right	The equity shareholders enjoy voting rights.	The preference shareholders do not have voting rights.
(v) Accumulation of Dividend	The dividends on equity shares are not accumulated and therefore cannot be carried forward.	The unpaid dividends are accumulated and are carried forward to the future years in case of cumulative preference shares.

It may be noted that the companies have to follow a prescribed procedure for issue of shares as per the Companies Act 2013 and the guidelines issued by Securities and Exchange Board of India (SEBI).

ISSUE OF DEBENTURES

The companies can raise long term funds by issuing debentures that carry assured rate of return for investors in the form of a fixed rate of interest. It is known as debt capital or borrowed capital of the company. The debenture is a written acknowledgement of money borrowed. It specifies the terms and conditions, such as rate of interest, time of repayment, security of ered, etc. These are of ered to the public to subscribe in the same manner as is done in the case of shares.

The debenture holders are the creditors of the company and are entitled to get interest irrespective of profit earned by the company. They do not have any voting right. So they do not interfere in the day-to-day management of the business. Ordinarily, debentures are fully secured. In case the company fails to pay interest on debentures or repay the principal amount, the debenture holders can recover it from sale of its assets.

Merits of Debentures

(a) Debentures are secured loans. On winding up of the company, they are repayable before making any payment to the equity and preference shareholders.

(b) The debenture holders get assured return irrespective of profit.

(c) Issue of debentures enables the company to provide high return to equity shareholders when the earnings of the company are good. This is called Trading on Equity.

(d) Debenture holders have no right either to vote or take part in the management of the company. So by issuing debentures the company raises the additional capital without diluting the control over its management.

(e) Interest paid on debentures is treated as an expense and is charged to the profits of the company. The company thus, saves income tax.

Limitations of Debentures

(a) If the earnings of the company are uncertain and unpredictable, issue of debentures may pose serious problems due to fixed obligation to pay interest and repay the principal. So, when the company expects good and stable income, then only it should issue debentures.

(b) The company, which issues debentures, creates a charge on its assets in favour of debenture holders. So a company not having enough fixed assets cannot borrow money by issuing debentures.

(c) The assets of the company once mortgaged cannot be used for further borrowing. So, issue of debentures reduces the borrowing capacity of the company.

Types of Debentures

Debentures may be classified as:

(i) Redeemable and Irredeemable Debentures: The debentures which are repayable on a specified date are called redeemable debentures. On the other hand, there is no fixed time by which the company is bound to pay back the money in case of irredeemable debentures. These debenture holders cannot demand to get back their money as long as the company does not make any default in payment of interest. So these debentures are also called perpetual debentures.

(ii) Convertible and Non-convertible Debentures: The holders of convertible debentures are given the option to convert their debentures into equity shares. But in case of non-convertible debentures the company does not give any such option.

(iii) Secured and Unsecured Debentures: Secured debentures are issued with a charge on the assets of the company as security. This charge may be fixed i.e., on specified asset, or it may be floating. Secured debentures are also known as mortgaged debentures. On the other hand, unsecured debentures are issued with merely a promise of payment without having any charge on any assets as security. So these debentures are also known as naked or simple debentures. Now-a-days debentures are invariably issued as secured debentured.

(iv) Registered and Bearer Debentures: For registered debentures the issuing company maintains a record of the debenture holders. Any sale or transfer of such debentures must be registered with the company. On the other hand, bearer debentures are just like negotiable instruments and transferable by mere delivery. The company keeps no record of such debenture-holders. Interest coupons are attached to them and anybody can produce the coupon to get the interest.

After having some idea about shares and debentures let us find out the difference between them.

Difference between Shares and Debenture

Basis of Difference	Shares	Debentures
1. Status	Shareholders are the owners of the company. They provide ownership capital which is not refundable unless the company is liquidated.	Debenture holders are the creditors of the company. They provide loans generally for a fixed period, which are to be paid back.
2. Nature of return on investment	Shareholders get dividends. Its amount is not fixed as it depends on the profit of the company.	Interest is paid on debentures at a fixed rate. Interest is payable even if the company is running at a loss.
3. Rights	Shareholders are the real owners of the company. They have the right to vote and determine the policies of the company.	Debenture holders do not have the right to attend meetings of the company. So they have no say in the management of the company.

4. Security	No security is required to issue shares.	Generally debentures are secured. So, sufficient fixed assets are required when debentures are to be issued.
5. Order of Repayment	Share capital is paid back only after paying the debenture holders and creditors.	Debenture holders have the priority of repayment over shareholders.
6. Risk	Risk is high due to uncertainty of returns.	Little risk due to certainty of return.

Loan from Special Financial Institutions (SFI)

After independence a large number of financial institutions have been established in India with the primary objective to provide medium and long-term financial assistance to industrial enterprises. Institutions like Industrial Finance Corporation of India (IFCIs), Industrial Reconstruction Bank of India, State Financial Corporation (SFCs),

State Industrial Development Corporation (SIDCs), have been established to provide financial support to set up new enterprises as wel expansion and modernization of the existing enterprises.

These financial institutions grant loans for a maximum period of 25 years. These loans are covered by mortgage of company's property and/or hypothecation of stocks shares etc. The major benefits derived from such loans are:

(i) The rate of interest payable is lower than the market rate and (ii) the amount of loan is large.

However, it involves a number of legal and technical formalities and also the negotiation period is usual y long. The financial institutions often nominate one or two directors to have some degree of control over the utilisation of funds and the functioning of the company.

Borrowing from Commercial Banks

Traditional y, commercial banks in India were not granting long-term loans. They were granting loans only for a short period not extending beyond one year. But recently they have started giving loans for a period of 3 to 5 years. Normal y they give term loans for one or two years. The period is extended at intervals and in some cases loan is given directly for 3 to 5 years. Commercial banks provide long-term finance to smal - scale units in the priority sector.

Merits

The merits of long-term borrowing from banks are as follows:

1. It is a flexible source of finance, as loan amount can be increased as per the business need and can be returned in advance when funds are not needed.

2. Banks keep the financial operations of their clients secret.

3. Time and cost involved are lower as compared to issue of shares, debentures etc.

4. Banks do not interfere in the internal af airs of the borrowing concern.

5. Loans can be paid back in easy instal ments.

6. In case of smal -scale industries and industries in vil ages and backward areas, the interest charged is very low.

Limitations

following are the limitations of long term borrowing from commercial banks:

1. Banks require personal guarantee or pledge of assets while granting loans. So the business cannot raise further loans on these assets. Thus, it reduces the borrowing capacity of the borrowers.

2. In case the short-term loans are extended again and again, there is always uncertainty about its continuity.

3. Too many formalities have to be fulfilled for get ing term loans from banks. These formalities make the borrowings from banks time consuming and inconvenient.

Public Deposits

It is a very old method of finance practiced in India. When commercial banks were not there, people used to deposit their savings with business concerns of good repute. Even today it is a very popular and convenient method of raising short and medium term finance. Under this method companies can raise funds by inviting their shareholders, employees and the general public to deposit their savings with the company. To attract the public, the company usual y offers a higher rate of interest than the interest on bank deposit. The period for which companies accept public deposits range between six months to 36 months.

Procedure of raising funds through Public Deposits

When an organisation wants to raise funds through public deposits it give an advertisement in the newspapers. The advertisement highlights the achievements and future prospects of the undertaking and invites the investors to deposit their savings with it. It declares the rate of interest, which may vary depending upon the period for which money is deposited. It also declares the time and mode of payment of interest and the repayment of deposits. Normal y they appoint some local firms to act as brokers and help them in providing service to the depositors. Keeping in view the malpractices of certain companies, such as non-payment of interest for years together and not refunding the money, the Government has framed certain rules and made certain amendments in the Companies Act for their security. The maximum rate of interest and brokerage payable are decided by the Reserve Bank of India. The amount of deposit should not exceed 25% of the paid up capital and general reserves. The company is also required to maintain a Register of Depositors containing all particulars as to public deposits.

Merits

following are the merits of public deposits:

1. Simple and easy: The method of borrowing money through public deposit is very simple. It does not require many legal formalities. It has to be advertised in the newspapers and a receipt is to be issued.

2. No charge on assets: Public deposits are not secured. They do not have any charge on the fixed assets of the company.

3. Economical: Expenses incurred on borrowing through public deposits are much less than expenses on other methods like issue of shares and debentures.

4. Flexibility: Public deposits bring flexibility in the capital structure of the company. These can be raised when needed and refunded when not required.

Limitations

following are the limitations of public deposits.

1. Uncertainty: A concern should be of high repute and have a high credit rating to at ract public to deposit their savings. There may be sudden withdrawals of deposits, which may create financial problems. Depositors are regarded as fair weather friends.

2. Insecurity: Public deposits do not have any charge on the assets of the concern. It may not always be safe to deposit savings with companies, particularly those, which are not very sound financial y.

3. Limits on the amount raised: There are limits on the amount that can be raised through public deposits.

Retention of Profit

Like an individual, companies also set aside a part of their profits to meet future requirements of capital. The portion of the profits, which is not distributed among the shareholders but is retained and reinvested in business, is called retained earnings or ploughing back of profits. As per Indian Companies Act 2013, companies are required to transfer a part of their profits in reserves like General Reserve, Debenture Redemption Reserve and Dividend Equalisation Reserve etc. These reserves can be used to meet long-term financial requirements like purchase of fixed assets, renovation and modernisations etc. This method of financing long-term financial requirement is also called as Retention of Profit.

Merits

Following are the benefits of retention of profit:

1. Cheap source of capital: No expenses are incurred when capital is available from this source. There is no obligation on the part of the company either to pay interest or pay back the money. It can safely be used for expansion and modernisation of business.

2. Financial stability: A company which has enough reserves can face ups and downs in business. Such companies can continue with their business even in depression, thus building up its goodwil .

3. Benefits to the shareholders: Shareholders are assured of a stable dividend. When the company does not earn enough profit it can draw upon its reserves for payment of dividends. Not only that their holding size can improve with issue of bonus shares. Due to reserves, there is capital appreciation, i.e., the value of shares may go up in the share market.

Limitations

Following are the limitations of retention of profit:

1. High Profit required: This method of financing is possible only when the company earns huge profits and that too for many years.

2. Dissatisfaction among shareholders: Accumulation of profits often leads to low dividend payment by companies. Not only that, the companies may not utilise it for issue of bonus shares to avoid higher dividend payment. This may create dissatisfaction among the shareholders.

3. Mismanagement of funds: Capital accumulated through retained earnings encourages management to be less careful with utilisation of funds which may lead to low profitability. It is not in the long run interest of the shareholders.

Lease Financing

Lease is a contract whereby one can use the assets of the other with due permission of the owner on payment of rent without purchasing them. The owner of the asset is called 'lessor' and the user is called lessee. The period of use is called the lease period after which the lessee may opt for purchase of the asset.

Leasing is an arrangement that enables a business enterprise to use and exercise complete control over the assets without owning it. The owner gets rent in return and at any time as per the terms of the contract he can cancel the agreement. This system helps the business to use the plants and machinery and other fixed assets for a long period of time without investing a large amount of money in purchasing them. At the end of the lease period the asset goes back to the owner. The owner of the assets also has the option of sel ing it to the user at a reduced price. Sometimes the user company may request the leasing company to purchase its existing assets and allow them to use the same assets on lease basis. This enables the company to save the long-term funds that can be utilised for other purposes. This is known as 'sale and lease back' system.

Foreign Investment

Funds for the business can also be raised from foreign sources by means of Foreign Direct Investment (FDI). It can be obtained by col aborating with the foreign companies. It enables the Indian companies to secure equity capital through subscription of foreign col aborators to their share capital. The companies can also take loan from International Financial Institutions like The World Bank and International Finance Corporation either directly or by way of refinancing. The sale of shares to the persons of Indian origin and nationality, living abroad (Non- Resident Indians or NRIs) is another method of raising long-term funds of business. A non-resident Indian or a company control ed by non-resident Indians can invest within the prescribed limits of the paid up capital of an Indian company.

Fixed & Working Capital

Every company requires capital for the various purposes. On the basis of the purpose of capital, it is called fixed capital or working capital. Fixed capital refers to the investment in long term assets. These affect the growth, profitability and risk of the business in the long run. Besides this, every organization needs to invest in current assets. This investment facilitates smooth day to day transactions of the business. In this unit of the module, we shal focus ourselves on the meaning of fixed and working capital and the factors af ecting them.

1. Fixed Capital: Funds required financing the fixed assets. Fixed assets are those which remain in the business for more than one year, like plant and machinery, furniture and fixtures, land and building, vehicles, etc.

2. Capital Budgeting Decision: This relates to deciding as to how much capital should be invested in long term assets.

3. Working Capital: This refers to the difference between the short term assets and short term liabilities. 93 PGT Commerce In-service Training Module - 2 2016 - 17

4. Business Cycle: The business cycle is the fluctuation in economic activity that an economy experiences over a period of time. A business cycle is basically defined in terms of periods of expansion or recession. During expansions, the economy is growing in real terms (i.e. excluding inflation), as evidenced by increases in indicators like employment, industrial production, sales and personal incomes. During recessions, the economy is contracting, as measured by decreases in the above indicators. Expansion is measured from the trough (or bot om) of the previous business cycle to the peak of the current cycle, while recession is measured from the peak to the trough.

5. Production Cycle: The period during which the objects of labor (raw products and materials) remain in the production process, from the beginning of manufacturing through the output of a finished product. In addition to the working time, the working time, the production cycle includes interruptions in production owing to physical, chemical and biological (natural) processes (for example, the period required for tanning leather), the character of the objects of labor, or the technology and organization of production.

6. Operating Efficiency: Operational efficiency is the capability of an enterprise to deliver products or services to its customers in the most cost-effective manner possible while stil ensuring the high quality of its products, service and support.

7. Inflation: Inflation is defined as a sustained increase in the general level of prices for goods and services. It is measured as an annual percentage increase.

INTRODUCTION: Fixed capital means the sum of fixed assets required by an organization and their sources of funds in the form of equity shares, preference shares, debentures and long term loans. Decisions of purchase of these assets are also called capital budgeting decisions or fixed capital decisions. These include purchase of fixed assets such as land, building, plant and machinery, etc. These long term assets last for more than one year and are financed through fixed capital. There are a few factors which decide the requirement of fixed capital some of them are listed below.

Factors affecting the requirement of Fixed Capital

1. Nature of business: A manufacturing concern would require more fixed capital as compared to a trading company.

2. Scale of operations: Companies operating on larger scale require more fixed capital compared to smal scale enterprises.

3. Choice of technique: Capital intensive organizations require higher investment in plant and machinery whereas labour intensive organizations require lesser investment in fixed assets. Their fixed capital requirement is lower.

4. Technology upgradation: Replacement of obsolete assets requires huge capital investments. Like replacement of computers, etc.

5. Growth prospects: Higher growth of organization requires higher investment in fixed assets

6. Diversification: Companies may diversify by including more product range. This would result in requirement of more fixed capital.

7. Financing alternatives: A company using fixed assets on lease requires less fixed capital.

8. Level of Col aboration: A company in col aboration with another company may use fixed assets jointly with the other company, thus requiring lesser fixed capital.

Working Capital: To produce inventory, companies require a certain amount of capital to run its operating cycle. This is financed through short term funds and is called working capital. This refers to the difference between sum of short term assets such as cash, bank, trade receivables and sum of short term liabilities such as creditors, bil s payable etc.

Factors affecting the requirement of Working Capital

1. Nature of business: The manufacturing company requires huge amount of working capital because they have to convert raw material into finished goods. In case of trading concern, requirement of working capital is less since the length of operating cycle is smal .

2. Scale of operation: Organisations running on large scale require large working capital and vice versa.

3. Business Cycle Fluctuations: During the boom period, more demand for the stock is there, so requirement of working capital is more and vice versa.

4. Seasonal factors: Companies sel ing seasonal goods require more working capital during the season.

5. Length of operating cycle: The time between the acquisitions of raw material to sale of finished goods is called the operating cycle. A longer operating cycle requires more working capital and vice versa.

6. Credit allowed to debtors: A company which follows a short term credit policy can manage with less working capital.

7. Credit availed from creditors: If suppliers of raw material allow short creditperiod, then company wil require more working capital to make payments to

creditors.

8. Operating efficiency: Firms with high degree of efficiency have low wastage and can manage with less working capital and vice versa.

9. Availability of raw material: If raw materials are easily available, lessor working capital is required.

10. Growth prospects: Firms planning expansion require more working capital.

11. Level of competition: In a competitive market, company has to adopt liberal credit policy and to supply goods on time; higher inventory would have to be maintained. Hence, more working capital would be required.

12. Inflation: Possibility of price rise wil result in increase in working capital requirement.

Let's Sum up

Based on the period for which the funds are required, business finance is classified as:

(a) Short-term finance (for a period of less than one year)

(b) Medium-term finance (for one year to five years)

(c) Long-term finance (for more than five years).

- There are two sources of raising the required funds by the business (i) internal source– owner's capital, retained earnings, and (ii) external source-friends and relatives, banks, other financial institutions, money lenders, capital market, etc.
- Methods of raising short-term finance:

1. Trade Credit

2. Bank Credit – loans and advances, cash credit, bank overdraft, discounting of bills.

3. Factoring

4. Customers' advances

5. Instal ment credit

6. Loans for unorganised sectors.

- The loans and advances are granted by the banks by taking some security that wil ensure the bank about safe return of its money. Securities of ered against bank credit may be of two types:

(i) Personal security

(ii) Security of assets like moveable goods, shares and stock, documents of title to goods, fixed deposit receipts, Life insurance policies, jewel ery or precious metals etc.

- The methods of raising long term finance are:

(i) Issue of shares – Share is the smal est unit into which the total capital of the company is divided. There are mainly two types of shares.

(a) Equity shares: These are shares which do not enjoy any preferential right in the mat er of payment of dividend or repayment of capital. The equity shareholders get dividend only after making the payment of dividends on preference shares.

There is no fixed rate of dividend for equity shareholders.

(b) Preference shares: They carry preferential rights in respect of dividend and return of capital. The rate of dividend on preference shares is fixed.

The different types of preference shares that a company can issue are:

- Convertible and non-convertible preference shares

- Cumulative and non-cumulative preference shares

- Participating and non-participating preference shares, and

- Redeemable and irredeemable Preference shares.

(ii) Issue of Debentures: The companies also raise funds through debentures, which carry an assured rate of return for the investors, in the form of a fixed rate of interest. Debenture holders are the creditors of the company and are entitled to get interest irrespective of profit earned by the company. They do not have any voting right.

(iii) Loan from Special Financial Institutions (SFI)

(iv) Borrowings from Commercial Banks

(v) Public Deposits

(vi) Retained Earnings

(vii) Lease Financing

(viii) Foreign Investment

(ix) Global Depository Receipts.

Check your Progress

1. Give specific examples of the following kinds of assets that may be given as security for obtaining bank credit:

(a) Document of title to goods

(b) Moveable goods

(c) Jewel ery or precious metals

2. Which type of bank credit is being referred to here?

(a) Accountholder is allowed to withdraw an amount in excess of the balance in his current account in the bank.

(b) The bank advances money against a document, after deducting some discount.

(c) Interest is charged on the amount actual y withdrawn, and not on the entire amount sanctioned.

(d) The amount is credited to a separate account by the bank and interest is paid by the borrower on the whole of this amount, irrespective of the amount actual y drawn.

3. Complete the following chart that compares equity shares and preference shares:

Basis of Difference	Equity shares	Preference shares
(1) Payment of dividend on shares	Dividend paid after paying dividend on preference shares	(a) ....
(2) Return of capital onwinding up of company	(b)	(b) Capital is refunded in preference over the equity
(3) Voting rights	(c)	(c) Do not carry voting Rights
(4) Accumulation of Dividend	(d) Dividend is not accumulated and therefore cannot be carried forward	(d) ....

4. Some of the features of the different methods of raising long-term capital are given below. Identify the features that relate to equity shares, preference shares and debentures.

(i) In case of winding up of the company, the capital is refunded after payment of debentures but before payment to equity shareholders.

(ii) Their holders are creditors of the company for a fixed period.

(iii) Their holders are the owners of the company and enjoy voting rights.

(iv) Shareholders bear high degree of risk-in case of losses they do not get dividend and in case of winding up of the company, they are the last to get refund of their invested money.

(v) Their holders have no say in the management of the company and they do not have the right to at end the company's meetings.

5. Mention the difference between shares and Debentures, on the basis of the criteria listed below:

Basis	Shares	Debentures
1. Status		
2. Rights		
3. Security		
4. Risk		

6. Give the ful form of the following abbreviations:

(a) IFCI

(b) SFC

(c) SIDC

7. Which method of long-term financing, Public Deposit or Retention of Profits, is being referred to, in each of the following statements?

(a) Management is less careful about funds utilization by this method.

(b) To raise funds through this method, an advertisement is generally given in the newspapers.

(c) They of ers flexibility and the funds can be refunded when not required.

(d) They of er benefit to shareholders as company may draw upon its reserves to pay dividend to them.

(e) No obligation on the company to pay interest on it or repay the money.

8. (a) Give the meaning of lease financing.

(b) List any two limitations of long-term borrowings from Commercial Banks.

9. What is meant by 'Discounting of Bil '?

10. What is 'Trading on Equity'?

11. What is meant by lease financing?

12. State the meaning of 'sale and lease back' system.

13. State the meaning of 'Preference shares'.

14. Explain any two ways in which a business enterprise can obtain Bank Credit.

15. Give two merits and two limitations of equity shares, from the point of view of the management.

16. Explain the four types of preference shares a company can issue.

17. What are 'Debentures'? Describe three merits and three limitations of debentures as a source of long-term finance for a company.

18. differentiate between 'Shares' and 'Debentures' as sources of long-term finance.

19. What is meant by Special Financial Institutions (SFIs)? Explain two merits and two demerits of taking loans from SFIs as a source of long-term funds.

20. Write explanatory notes on:

(a) Retention of Profits, and (b) Public Deposits, as methods of Long-term finance

ANSWERS Key

1. (a) Bil of Lading, Railway Receipts, Warehouse Warrant etc.

(b) Stock of raw material like leather, chemicals etc. or finished goods like industrial machinery, leather shoes etc. (or any other suitable examples).

(c) Gold Bangles, Diamond Necklace, Silver ware (or any other suitable examples).

2. (a) Bank Overdraft

(b) Discounting of Bil

(c) Cash Credit

(d) Loans and Advances.

3. (a) Dividend is paid on these shares in preference to the equity shares.

(b) Share capital refunded only after the refund of preference share capital.

(c) Shareholders enjoy voting rights.

(d) Unpaid dividends are accumulated and are carried forward to the future years, in case of cumulative preference shares.

4. (i) Preference shares

(ii) Debentures

(iii) Equity shares

(iv) Equity shares

(v) Debentures

5.

Basis	Shares	Debentures
1. Status	Owners of the company	Creditors of the company.
2. Rights	Right to vote and determine policies of the company.	No right to attend company's meetings. No say in company's management.
3. Security	Not required	Generally secured. So sufficient fixed assets required to issue debentures.
4. Risk	High	Little risk

6. (a) Industrial Finance Corporation of India

(b) State Financial Corporation

(c) State Industrial Development Corporation

7. (a) Retention of Profits

(b) Public Deposit

(c) Public Deposit

(d) Retention of Profits

(e) Retention of Profits